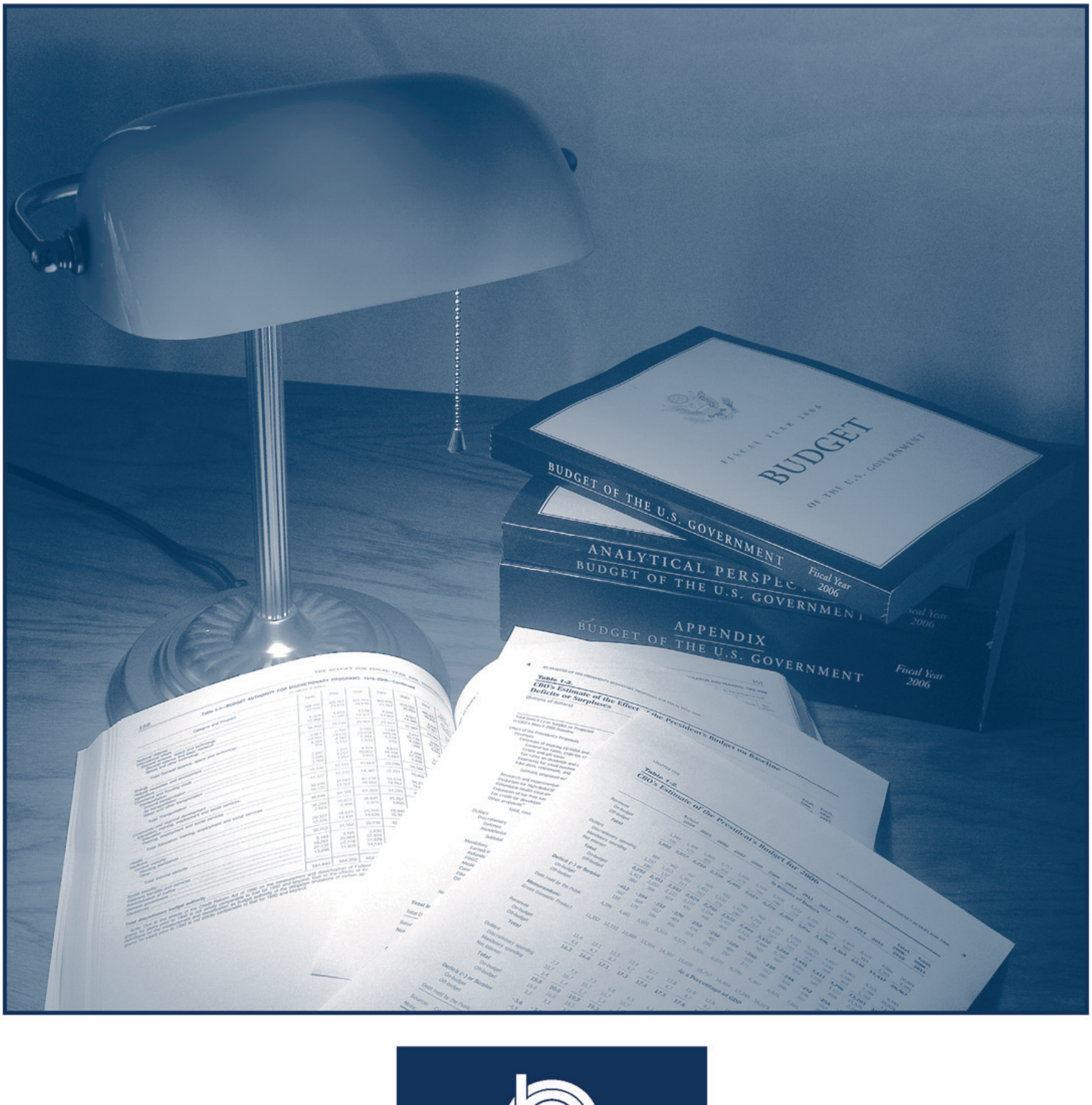
CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

An Analysis of the President's Budgetary Proposals for Fiscal Year 2006



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March 2005

The Congress of the United States ■ Congressional Budget Office

Notes

Unless otherwise indicated, the years referred to in this report are fiscal years.

Numbers in the text and tables may not add up to totals because of rounding.

Supplemental data on mandatory spending are available from within the electronic version of this report on the Congressional Budget Office's Web site (www.cbo.gov).

Preface

This Congressional Budget Office (CBO) analysis of the President's budgetary proposals for fiscal year 2006—prepared at the request of the Senate Committee on Appropriations—was produced by the staffs of CBO's Budget Analysis, Macroeconomic Analysis, and Tax Analysis Divisions under the supervision of Robert Sunshine, Robert Dennis, and Thomas Woodward, respectively. The baseline revenue estimates and the estimates of certain revenue proposals were prepared by CBO; most of the estimates of the President's revenue proposals were prepared by the Joint Committee on Taxation (JCT). This report expands on CBO's preliminary analysis, which was released on March 4, 2005. In some instances, JCT has slightly revised the estimates incorporated there; those updated revenue estimates are not reflected in this report.

Barry Blom and Ann Futrell of CBO's Projections Unit wrote Chapter 1 under the supervision of Jeff Holland, with assistance from Mark Booth and Pamela Greene. Ben Page of the Macroeconomic Analysis Division wrote Chapter 2 and Appendixes C and D with assistance from Bob Arnold, Paul Burnham, Ufuk Demiroglu, Eva de Francisco, Mark Lasky, Shinichi Nishiyama, Larry Ozanne, Frank Russek, and Sven Sinclair. Thomas Bradley of the Health Cost Estimates Unit wrote Appendix A, and Noah Meyerson of the Health and Human Resources Division wrote Appendix B. The contributors to the revenue and spending projections underlying this report are listed in Appendix E.

Leah Mazade and Christian Spoor edited the report, and Christine Bogusz and John Skeen proofread it. Maureen Costantino took the photograph for the cover and prepared the report for publication. Lenny Skutnik printed the initial copies, and Annette Kalicki produced the electronic version for CBO's Web site (www.cbo.gov).

Douglas Holtz-Eakin
Director

March 2005

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CHAPTER

1

CBO's Estimates of the President's Budget for 2006

At the request of the Senate Committee on Appropriations, the Congressional Budget Office (CBO) has analyzed the President's budget request for fiscal year 2006 using its own economic assumptions and estimating techniques, with contributions from the Joint Committee on Taxation (JCT). This report presents CBO's analysis of that budget, which provides more details than the preliminary report released on March 4, 2005.

Overview of CBO's Estimates

According to CBO's estimates, carrying out the proposals in the President's budget would result in a deficit of $394 billion in 2005, equal to 3.2 percent of the nation's gross domestic product (GDP). That deficit would be smaller than the one recorded in 2004, which totaled $412 billion, or 3.6 percent of GDP (see Table 1-1). The estimate for 2005 includes outlays of $32 billion resulting from the President's recent request for supplemental appropriations, mainly for military activities in Iraq.

In 2006, the deficit under the President's budgetary proposals would shrink to $332 billion, CBO estimates—but the President's request for that year omits additional funds to continue U.S. operations in Iraq and Afghanistan. Consequently, CBO's estimate of the budget's effects in 2006 reflects only outlays for those operations that would result from the 2005 supplemental request (a total of $82 billion in budget authority) and from appropriations enacted for previous years. Additional funding to keep the operations at roughly the same level as expected for 2005 would add about $40 billion to the 2006 deficit, bringing it to between $370 billion and $375 billion, or 2.9 percent of GDP.[1]

Beyond 2006, the deficit would decline further as a percentage of GDP under the President's proposals—to 2.0 percent of GDP in 2007 and then to 1.3 percent of GDP by 2015 (the end of CBO's 10-year projection period). Over the 2006-2015 period, deficits under the President's budget would total $2.6 trillion, or 1.6 percent of GDP, CBO estimates. Federal debt held by the public would grow to 39 percent of GDP in the next few years, up from 37 percent of GDP at the end of 2004; it would then gradually fall back to that level by 2015. However, such figures reflect neither significant spending for military operations in Iraq and Afghanistan nor the potential budgetary impact of the President's proposal to provide individual investment accounts as part of an overhaul of the Social Security program. The President's budget offers no details about other possible changes to Social Security, which makes estimating the impact of individual accounts difficult because such changes would affect participation in the accounts.

The President's budget does not provide year-by-year estimates of spending and revenues after 2010. Rather, for each proposed change to laws that govern revenues or mandatory spending, the budget specifies a total effect through 2015. For discretionary spending, the budget provides details just for 2005 and 2006; for 2007 through 2010, such funding is shown only in the aggregate, by budget function.[2] CBO incorporated those aggregate levels in its estimates and calculated discretionary outlays for the 2011-2015 period by projecting the amount of dis-

1. That assumption is consistent with the first policy alternative presented in Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015* (January 2005), Table 1-3.

2. Budget functions are the 20 broad categories into which the federal budget is divided so that all budget authority and outlays can be presented according to the national interests they address (such as defense, agriculture, transportation, and so forth).

Table 1-1.

Comparison of Projected Deficits and Surpluses in CBO's Estimate of the President's Budget and in CBO's March Baseline

(Billions of dollars)

	Actual 2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
								CBO's Estimate of the President's Budget						
On-Budget Deficit	-567	-569	-517	-484	-474	-487	-486	-539	-512	-535	-544	-557	-2,449	-5,135
Off-Budget Surplus	155	175	186	206	224	241	257	271	282	290	297	301	1,113	2,554
Total Deficit	**-412**	**-394**	**-332**	**-278**	**-250**	**-246**	**-229**	**-268**	**-230**	**-244**	**-247**	**-256**	**-1,336**	**-2,581**
								CBO's March 2005 Baseline						
On-Budget Deficit	-567	-539	-487	-477	-473	-463	-461	-370	-229	-226	-203	-183	-2,361	-3,571
Off-Budget Surplus	155	175	189	209	227	244	260	275	286	295	302	305	1,129	2,591
Total Deficit (-) or Surplus	**-412**	**-365**	**-298**	**-268**	**-246**	**-219**	**-201**	**-95**	**57**	**69**	**99**	**122**	**-1,232**	**-980**
								Difference (President's budget minus baseline)						
On-Budget Deficit	0	-30	-31	-7	-1	-24	-25	-169	-283	-309	-341	-374	-88	-1,564
Off-Budget Surplus	0	0	-3	-3	-3	-3	-3	-4	-4	-4	-5	-5	-16	-37
Total Deficit	**0**	**-30**	**-34**	**-10**	**-4**	**-28**	**-28**	**-173**	**-287**	**-313**	**-346**	**-378**	**-104**	**-1,601**
Memorandum:														
Total Deficit as a Percentage of GDP														
CBO's estimate of the President's budget	-3.6	-3.2	-2.6	-2.0	-1.8	-1.6	-1.5	-1.6	-1.3	-1.4	-1.3	-1.3	-1.9	-1.6
CBO's baseline	-3.6	-3.0	-2.3	-2.0	-1.7	-1.5	-1.3	-0.6	0.3	0.4	0.5	0.6	-1.7	-0.6
Debt Held by the Public as a Percentage of GDP														
CBO's estimate of the President's budget	37.2	38.3	39.0	39.1	39.0	38.8	38.5	38.5	38.2	37.9	37.6	37.3	n.a.	n.a.
CBO's baseline	37.2	38.1	38.5	38.6	38.5	38.2	37.8	36.7	34.8	33.0	31.1	29.1	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable.

cretionary budget authority recommended by the President for 2010 and adjusting that amount for inflation.

Total outlays under the President's budget would peak at 20 percent of GDP this year, CBO estimates, before declining to around 19 percent of GDP for most of the next 10 years (see Table 1-2). Spending for entitlements and other mandatory programs would grow at an average rate of 5.9 percent a year—faster than nominal GDP, which is projected to grow by 4.9 percent annually—whereas discretionary outlays would increase at an average rate of 1.2 percent a year. Revenues would remain relatively low by historical standards, rising from 16.8 percent of GDP this year to 17.1 percent in 2006 and to 18.0 percent by 2015.

The proposals in the President's budget would add $30 billion to the deficit that CBO now projects for 2005, mainly as a result of the proposed supplemental appropriations. Over the 2006-2010 period, those proposals would increase the cumulative deficit by $104 billion relative to CBO's baseline projections. Lower nondefense spending would largely offset higher defense spending. But proposed changes in tax laws—such as extending the reduced tax rates on dividends and capital gains that were enacted in 2003 and extending the research and experi-

Table 1-2.

CBO's Estimate of the President's Budget for 2006

	Actual 2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
							In Billions of Dollars							
Revenues														
On-budget	1,345	1,484	1,605	1,713	1,820	1,919	2,029	2,110	2,226	2,351	2,482	2,621	9,086	20,876
Off-budget	535	573	605	638	672	706	740	774	809	845	882	919	3,361	7,591
Total	**1,880**	**2,057**	**2,210**	**2,350**	**2,492**	**2,625**	**2,770**	**2,884**	**3,036**	**3,196**	**3,364**	**3,540**	**12,447**	**28,467**
Outlays														
Discretionary spending	894	962	947	926	931	949	968	993	1,006	1,033	1,057	1,083	4,721	9,893
Mandatory spending	1,237	1,313	1,382	1,451	1,532	1,626	1,718	1,832	1,918	2,053	2,185	2,330	7,709	18,028
Net interest	160	177	213	252	278	297	312	327	342	354	369	383	1,352	3,127
Total	**2,292**	**2,451**	**2,542**	**2,629**	**2,742**	**2,872**	**2,999**	**3,152**	**3,266**	**3,441**	**3,611**	**3,796**	**13,783**	**31,047**
On-budget	1,913	2,053	2,122	2,197	2,294	2,407	2,515	2,649	2,738	2,886	3,026	3,177	11,535	26,011
Off-budget	380	399	419	432	448	465	484	503	527	555	585	618	2,248	5,037
Deficit (-) or Surplus	**-412**	**-394**	**-332**	**-278**	**-250**	**-246**	**-229**	**-268**	**-230**	**-244**	**-247**	**-256**	**-1,336**	**-2,581**
On-budget	-567	-569	-517	-484	-474	-487	-486	-539	-512	-535	-544	-557	-2,449	-5,135
Off-budget	155	175	186	206	224	241	257	271	282	290	297	301	1,113	2,554
Debt Held by the Public	4,296	4,681	5,021	5,310	5,573	5,831	6,070	6,346	6,582	6,831	7,081	7,338	n.a.	n.a.
Memorandum:														
Gross Domestic Product	11,553	12,233	12,888	13,586	14,307	15,029	15,757	16,494	17,245	18,023	18,826	19,652	71,566	161,806
							As a Percentage of GDP							
Revenues														
On-budget	11.6	12.1	12.5	12.6	12.7	12.8	12.9	12.8	12.9	13.0	13.2	13.3	12.7	12.9
Off-budget	4.6	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Total	**16.3**	**16.8**	**17.1**	**17.3**	**17.4**	**17.5**	**17.6**	**17.5**	**17.6**	**17.7**	**17.9**	**18.0**	**17.4**	**17.6**
Outlays														
Discretionary spending	7.7	7.9	7.3	6.8	6.5	6.3	6.1	6.0	5.8	5.7	5.6	5.5	6.6	6.1
Mandatory spending	10.7	10.7	10.7	10.7	10.7	10.8	10.9	11.1	11.1	11.4	11.6	11.9	10.8	11.1
Net interest	1.4	1.4	1.7	1.9	1.9	2.0	2.0	2.0	2.0	2.0	2.0	1.9	1.9	1.9
Total	**19.8**	**20.0**	**19.7**	**19.3**	**19.2**	**19.1**	**19.0**	**19.1**	**18.9**	**19.1**	**19.2**	**19.3**	**19.3**	**19.2**
On-budget	16.6	16.8	16.5	16.2	16.0	16.0	16.0	16.1	15.9	16.0	16.1	16.2	16.1	16.1
Off-budget	3.3	3.3	3.3	3.2	3.1	3.1	3.1	3.0	3.1	3.1	3.1	3.1	3.1	3.1
Deficit (-) or Surplus	**-3.6**	**-3.2**	**-2.6**	**-2.0**	**-1.8**	**-1.6**	**-1.5**	**-1.6**	**-1.3**	**-1.4**	**-1.3**	**-1.3**	**-1.9**	**-1.6**
On-budget	-4.9	-4.7	-4.0	-3.6	-3.3	-3.2	-3.1	-3.3	-3.0	-3.0	-2.9	-2.8	-3.4	-3.2
Off-budget	1.3	1.4	1.4	1.5	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.5	1.6	1.6
Debt Held by the Public	37.2	38.3	39.0	39.1	39.0	38.8	38.5	38.5	38.2	37.9	37.6	37.3	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable.

Table 1-3.

CBO's Estimate of the Effect of the President's Budget on Baseline Deficits or Surpluses

(Billions of dollars)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006, 2015
Total Deficit (-) or Surplus as Projected in CBO's March 2005 Baseline	-365	-298	-268	-246	-219	-201	-95	57	69	99	122	-1,232	-980
Effect of the President's Proposals													
Revenues													
Extension of expiring EGTRRA and JGTRRA provisions													
General tax rates, child tax credit, and brackets	0	0	0	0	0	0	-96	-154	-158	-161	-166	0	-736
Estate and gift taxes	0	-1	-2	-2	-2	-3	-28	-55	-59	-67	-72	-9	-290
Tax rates on dividends and capital gains	0	0	0	-2	-13	-8	-22	-23	-25	-27	-28	-23	-148
Expensing for small businesses	0	0	0	-3	-4	-3	-2	-2	-2	-1	-1	-10	-19
Education, retirement, and other provisions	0	0	0	0	0	0	-4	-7	-8	-9	-9	0	-36
Subtotal, proposed extensions	0	-1	-2	-7	-19	-13	-152	-241	-251	-265	-277	-42	-1,228
Research and experimentation tax credit	0	-2	-5	-6	-7	-8	-9	-9	-10	-10	-11	-29	-78
Deduction for high-deductible health insurance	0	*	-2	-2	-3	-3	-3	-4	-4	-5	-5	-10	-33
Refundable health insurance tax credit	0	*	-1	-1	-1	-1	-1	-2	-2	-2	-1	-5	-12
Expansion of tax-free savings accounts	0	3	5	4	3	*	-2	-3	-3	-4	-5	15	-2
Tax credit for developers of affordable housing	0	*	*	*	-1	-1	-2	-3	-3	-3	-3	-3	-17
Other proposals[a]	*	-2	-2	-4	-9	-10	-9	-7	-5	-4	-4	-26	-55
Total Effect on Revenues	*****	**-3**	**-7**	**-16**	**-37**	**-37**	**-178**	**-268**	**-278**	**-293**	**-307**	**-100**	**-1,425**
Outlays													
Discretionary													
Defense	31	34	22	20	28	34	37	38	39	40	42	139	336
Nondefense	1	-2	-17	-30	-39	-46	-51	-54	-56	-58	-60	-134	-412
Subtotal, discretionary	32	32	5	-10	-11	-12	-14	-16	-17	-17	-18	5	-77
Mandatory													
Earned income and child tax credits	*	*	*	*	*	*	*	16	16	16	15	-1	62
Refundable health credits	0	*	6	6	6	7	7	6	6	6	6	26	57
Pension Benefit Guaranty Corporation	0	*	-5	-5	-4	-4	-4	-4	-3	*	*	-18	-29
Medicaid and SCHIP	*	-1	-1	-2	-2	-2	-3	-3	-4	-4	-5	-9	-27
Commodity Credit Corporation	0	*	-2	-2	-2	-2	-2	-2	-2	-2	-2	-7	-16
Education programs	-3	-2	-1	*	*	*	1	1	1	2	2	-3	4
Other proposals	*	*	-3	-4	-3	-4	-4	-4	-4	-4	-4	-14	-34
Subtotal, mandatory	-3	-3	-5	-7	-5	-5	-5	10	11	13	13	-26	16
Net interest	*	2	4	5	6	8	13	25	41	57	76	25	237
Total Effect on Outlays	**29**	**31**	**3**	**-12**	**-9**	**-9**	**-5**	**19**	**35**	**52**	**71**	**4**	**176**
Total Impact on the Deficit or Surplus	**-30**	**-34**	**-10**	**-4**	**-28**	**-28**	**-173**	**-287**	**-313**	**-346**	**-378**	**-104**	**-1,601**
Total Deficit Under the President's Proposals	-394	-332	-278	-250	-246	-229	-268	-230	-244	-247	-256	-1,336	-2,581

Sources: Congressional Budget Office; Joint Committee on Taxation.

Note: * = between -$500 million and $500 million; EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003; SCHIP = State Children's Health Insurance Program.

a. These numbers represent estimates from the Joint Committee on Taxation (JCT) as of March 4, 2005. JCT later made relatively minor revisions to a few of the estimates, but CBO did not receive those revisions in time to incorporate them into this analysis.

mentation tax credit—would reduce revenues by $100 billion through 2010 (see Table 1-3).[3]

The impact of the President's proposals on the cumulative deficit would be far greater over 10 years ($1.6 trillion) than over five years ($104 billion). Under the assumption in CBO's baseline that current laws and policies do not change, deficits turn into small surpluses by 2012, whereas under the President's policies, deficits would continue through 2015, CBO projects. Total revenues during the 2006-2015 period would be $1.4 trillion lower under the President's policies than in CBO's baseline, primarily because of the proposal to extend certain expiring tax provisions enacted in 2001 and 2003. Total discretionary spending would be $77 billion lower than the baseline level, but mandatory spending would be $16 billion higher. (Additional spending in the President's budget for refundable tax credits would be mostly offset by higher premiums paid to the Pension Benefit Guaranty Corporation, by reductions in Medicaid spending, and by other savings in mandatory programs.) Net interest costs on additional borrowing would add another $237 billion to the 10-year deficit.

The estimates described above—and presented in detail later in this chapter—come from an analysis of the President's budgetary proposals that does not account for the proposals' potential impact on the economy. Because any such impact could in turn influence how the proposals would affect the deficit, CBO has prepared a macroeconomic analysis of the President's budget, which is discussed in Chapter 2. That assessment uses a variety of models to indicate the range of potential economic and budgetary effects of the President's proposed policies. CBO has concluded that the macroeconomic effects and their resulting budgetary impact would most likely be modest.

3. For proposals that would amend the Internal Revenue Code, CBO is required by law to use estimates provided by the Joint Committee on Taxation. This analysis uses preliminary JCT estimates that were available as of March 4, 2005. JCT subsequently made minor revisions to a few estimates, as reflected in Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2006 Budget Proposal*, JCX-10-05 (March 9, 2005). Those revisions were made too late to be incorporated into this analysis. In total, they reduce projected revenues by an additional $0.8 billion for the 2006-2010 period and about $5 billion for the 2006-2015 period. (Projected outlays are not affected.)

Overall, CBO's estimates of the President's budget are similar to the Administration's estimates (see Table 1-4). Both CBO and the Administration expect the deficit to peak in 2005: CBO projects a deficit of $394 billion under the President's budget; the Administration expects a shortfall of $427 billion. For 2006, CBO estimates that the deficit would total $332 billion under the President's proposals, $58 billion less than the Administration's estimate of $390 billion. (Neither figure includes additional funding after 2005 for operations in Iraq and Afghanistan.) For the 2006-2010 period, CBO's total deficit projection of $1.34 trillion is only $57 billion less than the Administration's projection. (As noted above, the Administration did not provide estimates beyond 2010.)

CBO's estimates of outlays under the President's budget are smaller than those of the Administration—by $28 billion for 2005 and by a total of $110 billion (or 0.8 percent) for the 2006-2010 period. Those differences result mainly from differing estimates of Medicare spending under current law. CBO's projections of revenues under the President's budgetary proposals are also similar to the Administration's. CBO's revenue estimate is $4 billion higher than the Administration's for 2005 but $53 billion (or 0.4 percent) lower than the Administration's for the 2006-2010 period, mostly because of differing estimates of revenues under current law.

In conjunction with its analysis of the President's budget, CBO has updated its baseline projections to take into account new information from the budget and other sources. Nearly all of the changes to the updated baseline are technical, in that they do not result from new legislation or from changes to CBO's economic forecast. (Legislative changes have been minimal since January, when CBO published its previous baseline, and CBO has not updated its economic assumptions.)

CBO now projects that if current tax and spending policies remained the same, the cumulative deficit for the 2006-2015 period would total $980 billion—an increase of $125 billion from the January baseline projection. Much of that change stems from a rise of $70 billion in CBO's estimate of Medicare spending over the 2006-2015 period. The rise is primarily attributable to revised estimates of the cost of the prescription drug program (Part D of Medicare), which CBO has increased by $54 billion for the 2006-2015 period. (About $36 billion of that amount is expected through 2013, the period covered by CBO's original estimate of the cost of the Medi-

Table 1-4.

Sources of Differences Between CBO's and the Administration's Estimates of the President's Budget

(Billions of dollars)

	2005	2006	2007	2008	2009	2010	Total, 2006-2010
				Administration's Estimate			
Total Deficit Under the President's Proposals	-427	-390	-312	-251	-233	-207	-1,393
				Sources of Differences Between the Administration and CBO			
Revenue Differences[a]							
Baseline	5	35	10	-20	-37	-46	-59
Policy	*	-2	-3	5	12	-5	6
Total Revenue Differences	**4**	**32**	**6**	**-15**	**-25**	**-51**	**-53**
Outlay Differences							
Discretionary	-3	1	-10	-3	-4	-3	-19
Mandatory							
Baseline							
Medicare	-1	-14	-14	-16	-18	-17	-79
Veterans' benefits	-1	-1	-2	-4	-6	-8	-22
Food Stamps	-1	-4	-5	-4	-3	-4	-20
Other	-17	-11	-8	6	13	*	*
Subtotal, baseline	-20	-31	-29	-19	-14	-28	-121
Policy							
Medicaid and SCHIP	*	-2	*	2	2	2	4
Commodity Credit Corporation	0	1	-1	-1	-1	-1	-4
Student aid	-4	-1	1	1	1	1	4
Continued Dumping and Subsidy Offset Act	0	2	*	1	1	1	4
Power marketing administrations	0	*	*	*	1	1	3
Pension Benefit Guaranty Corporation	0	2	-1	-1	-1	-1	-3
Refundable health credits	0	*	3	1	-1	-1	2
Other	*	*	1	-2	2	2	4
Subtotal, policy	-4	2	4	*	4	4	14
Subtotal, mandatory	-24	-29	-25	-19	-10	-24	-106
Net interest	-1	2	7	6	2	-2	16
Total Outlay Differences	**-28**	**-26**	**-28**	**-16**	**-11**	**-29**	**-110**
All Differences[b]	**32**	**58**	**34**	*****	**-14**	**-22**	**57**
				CBO's Estimate			
Total Deficit Under the President's Proposals	-394	-332	-278	-250	-246	-229	-1,336

Continued

Table 1-4.

Continued

(Billions of dollars)

	2005	2006	2007	2008	2009	2010	Total, 2006-2010
Memorandum:							
Economic Differences							
Revenues	6	-2	-7	-13	-21	-36	-80
Outlays	*	2	5	1	-9	-23	-24
Total[b]	6	-4	-13	-14	-12	-13	-55
Technical Differences							
Revenues	-1	34	14	-3	-4	-15	27
Outlays	-28	-28	-33	-17	-2	-6	-86
Total[b]	27	62	47	14	-2	-8	112

Sources: Congressional Budget Office; Joint Committee on Taxation.

Note: * = between -$500 million and $500 million; SCHIP = State Children's Health Insurance Program.

a. The Administration's current-services estimates, contrary to the rules for constructing baselines, include certain proposals that would affect revenues between 2005 and 2010. CBO has classified differences in its estimates of those proposals as policy differences in this table; baseline differences for revenues reflect only differences in economic or technical assumptions about tax policy under current law.

b. Positive numbers denote that such differences cause CBO's estimate of the deficit to be lower than the Administration's estimate.

care Modernization Act.)[4] Changes in the estimated net cost of the basic Part D benefit account for more than half of the total revision, and changes in the cost of the low-income subsidy account for the rest. Those changes reflect both a refinement of CBO's estimating methods and provisions in the final rules governing formulary requirements and eligibility for the low-income subsidy that differ from what CBO had anticipated on the basis of legislative language.

Policy Proposals That Affect Mandatory Spending

Overall, CBO estimates that the policies proposed in the President's budget would generate net savings of $26 billion in mandatory spending over the 2006-2010 period (see Table 1-3 on page 4). Savings totaling $73 billion from various mandatory proposals would be partly offset by $25 billion in increased outlays for refundable tax credits and $22 billion in added spending for certain mandatory programs.

4. For more details, see Appendix A of this report and Congressional Budget Office, *Updated Estimates of Spending for the Medicare Prescription Drug Program* (March 4, 2005).

Over the entire 2006-2015 period, however, the Administration's proposals would produce a net increase of $16 billion in mandatory spending, CBO estimates. Higher spending for refundable tax credits would be largely offset by higher premium payments to the Pension Benefit Guaranty Corporation (PBGC) and by savings in Medicaid and other mandatory programs.

After issuing its budget request, the Administration released a general description of a plan to create personal investment accounts as part of an overhaul of the Social Security system (which did not appear in the President's budget). However, that plan is not sufficiently detailed or complete for CBO to estimate its budgetary impact at this time. (For a discussion of the proposal to create individual accounts, see Appendix B.)

Refundable Tax Credits

CBO and JCT estimate that the Administration's tax proposals—primarily those involving refundable tax credits—would add roughly $120 billion to mandatory outlays over the 2006-2015 period. The largest such change involves making permanent the recent expansion of the child tax credit. Before the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) was en-

acted, the maximum child tax credit per qualifying child was $500. The credit was refundable only for families with three or more qualifying children and had other limitations. If EGTRRA expires as currently scheduled at the end of calendar year 2010, the child credit will revert to its previous form in 2011. Instead, the President's budget proposes to permanently extend the tax credit in its current form—at $1,000 per child, with refundability not contingent on the number of qualifying children but limited to 15 percent of the amount of earned income in excess of $10,000 (indexed for inflation after 2001). That proposal, combined with proposed changes to tax brackets and tax rates that also affect refundable tax credits, would increase outlays by $62 billion over the 2006-2015 period, CBO and JCT estimate.[5] The President also suggests creating a refundable tax credit for the cost of health insurance and for certain contributions to health savings accounts. Together, those credits would add $57 billion to outlays over the 10-year period, according to CBO's and JCT's estimates. (The proposal for a refundable health insurance credit is described in more detail on page 15 in the section about revenue proposals.)

Pension Benefit Guaranty Corporation

The President's budget proposes changing the way in which liabilities for defined-benefit pension plans are measured—and consequently the extent to which plans are considered underfunded—and altering the premiums charged to underfunded plans. One change would be to discount pension obligations using interest rates that were based on the rates on corporate bonds instead of the rates on 30-year Treasury bonds. (That part of the proposal would also affect federal tax receipts.) In addition, the PBGC's board of directors would be given the authority to alter the premium rate charged to underfunded plans, which is currently set by statute at $9 per $1,000 of underfunding.

The Administration's proposal for the PBGC would also increase the flat-rate premiums charged to all sponsors of defined-benefit pension plans. The current premiums, which are based on the number of participants in each plan, would rise from $19 to $30 per participant in 2006 and be indexed to the growth of wages thereafter. Those flat-rate premiums were last increased in 1991, although the PBGC's insured liabilities have generally risen with wages.

In all, the proposal for the PBGC would increase the agency's premium collections by a total of $18 billion over the 2006-2010 period and $29 billion over the 2006-2015 period, CBO estimates.

Medicaid and SCHIP

The budget includes a series of proposals that, according to the Administration, would reduce federal spending for Medicaid by a total of $60 billion between 2006 and 2015. However, the Administration has not provided enough details for CBO to prepare its own estimates for some of the proposals that deal with restrictions on certain types of above-cost payments by states to health care providers and on payments for various social and rehabilitative services. (By the Administration's estimate, those proposals would save $23 billion over 10 years.)

CBO estimates that the rest of the proposals would lower federal Medicaid spending by a total of $37 billion over the 2006-2015 period—$16 billion from restricting the taxes that states impose on health care providers, $14 billion from reducing payments to pharmacies, $4 billion from cutting the federal matching rate for certain social services, and $3 billion from restricting eligibility for coverage of nursing home care. CBO estimates that the proposal to set a limit on the federal matching payments that could be available for administrative costs would generate no savings, because the proposed limits are higher than CBO's baseline projection for administrative costs.

The Medicaid savings proposed in the President's budget would be offset by an estimated $10 billion increase in spending over the 2006-2015 period—including additional outlays for efforts to enroll more children in Medicaid and in the State Children's Health Insurance Program (SCHIP). Overall, CBO estimates that the proposals that are detailed enough to analyze would reduce federal spending for Medicaid and SCHIP by a total of $27 billion through 2015.

Commodity Credit Corporation

The President's budget includes several proposals that, on net, would lower spending for the Department of Agriculture's Commodity Credit Corporation by a total of $16 billion over the 2006-2015 period. Most of those savings come from a proposal to limit the benefits that are available to producers through commodity loan pro-

5. The Administration's February 2005 baseline assumes that certain individual income tax provisions enacted in 2001 and 2003 will be extended. By contrast, CBO's baseline, following rules specified in law, assumes that those tax provisions—which raise outlays for the earned income and child tax credits—will expire as scheduled.

grams. The Administration also proposes lowering crop and dairy payments to farmers for all commodity programs by 5 percent, requiring the dairy price-support program to minimize expenditures, and imposing marketing assessments to be paid by sugar processors on all domestically produced sugar. In addition, the budget includes a proposal that would increase spending by extending the Milk Income Loss Compensation program for two years.

Education Programs

The President's 2006 budget contains a number of proposals that together would reduce spending for federal education programs by $3 billion over five years but increase spending by roughly $4 billion over 10 years, CBO estimates. The effects of those proposals on outstanding student loans would save an additional $3.4 billion in 2005, CBO estimates.[6]

The Administration's proposals would affect most of the parties to the student loan programs: borrowers, lenders, guaranty agencies, and the federal government. Proposals affecting borrowers—which would change eligibility criteria for loans as well as the terms, amounts, fees, and interest rates on those loans—would increase federal costs by $8.7 billion over the 2006-2015 period. However, proposals that would affect the returns to lenders would save $10.1 billion over that period. Those policies include imposing a fee of 25 basis points on nonconsolidated loans, increasing the fee on consolidated loans by 50 basis points, reducing the insured percentage for guaranteed loans, and permanently extending restrictions on special payments to lenders for loans based on the proceeds of certain tax-exempt bonds. The remaining proposals, which would affect guaranty agencies, would have small federal savings (about $1.4 billion) through 2015. The interactions between the provisions that would increase loan volumes and those that would reduce subsidies to lenders and guaranty agencies would boost savings by $5.3 billion over the 2006-2015 period—for total savings of more than $8 billion from the changes to student loan programs, CBO estimates.

In addition, the President's budget proposes recalling a portion of the Perkins loan revolving funds held by postsecondary institutions beginning in 2006. Under that proposal, as Perkins loans were repaid each year, schools would give the federal government a share of the repayments. CBO's baseline projects that under current law, the recall would begin to appear in the budget in 2012. As a result, the net effect on federal collections of the proposed recall would be diminished beginning in 2012 and turn negative beginning in 2013. CBO estimates that the proposal would save a total of $3.3 billion over the 2006-2010 period and $3.5 billion through 2015.

The Administration proposes using a portion of the savings from student loans and the Perkins loan recall to pay for raising the maximum Pell grant by $100 (to $4,150) for the 2006-2007 academic year and by another $100 annually for each of the following four years. That additional funding would be available only if the $4,050 maximum was funded through appropriations for 2006 and subsequent years. In addition to the increased maximum, the minimum grant would be raised each year, beginning with the 2007-2008 academic year, and would reach $600 by the 2010-2011 academic year. The proposal for Pell grants would increase outlays by $4.6 billion through 2010 and by $14.8 billion through 2015, CBO estimates.

Other Mandatory Spending Proposals

The President's budget also includes proposals that would affect receipts from the Federal Communications Commission's (FCC's) auctions of licenses to use parts of the electromagnetic spectrum. Those proposals include imposing new fees on licenses used for analog television broadcasts and on licenses awarded by methods other than auctions as well as extending the FCC's authority to conduct auctions beyond 2007. Overall, CBO estimates, implementing those proposals would increase offsetting receipts from fees and auctions (which are recorded in the budget as negative mandatory spending) by $12.7 billion over the 10-year projection period.

The President's budget request for veterans' health care includes proposals that would increase offsetting receipts and decrease mandatory spending by a total of $2.5 billion over five years and $5.3 billion over 10 years, CBO estimates. The Administration seeks to charge veterans with income above certain thresholds an annual enrollment fee of $250 and raise their copayment for a 30-day prescription from $7 to $15. Under current law, similar receipts—such as those from third-party insurance payments and the current $7 copayment for prescriptions—

6. That figure represents the estimated change in the present value of outstanding federal loans and loan guarantees. Under the Federal Credit Reform Act, such changes, known as loan modifications, are recorded in the year that legislation is enacted.

are classified as discretionary offsetting collections. (The President's budget proposes increasing discretionary appropriations for veterans' health care by the amount of the new mandatory receipts.)

The President's budget also includes a proposal to repeal the Continued Dumping and Subsidy Offset Act (CDSOA), which requires the federal government to disburse collections of antidumping and countervailing duties to the U.S. industries whose petitions for relief resulted in the imposition of the duties. In the past, those collections have averaged about $300 million per year. However, the United States and Canada are in the midst of a dispute about duties collected from exporters of Canadian softwood lumber. The assessments in question are much larger—approaching $4 billion—than previous duties and outlays under the CDSOA. Because CBO cannot predict the outcome of that dispute, its baseline assumes an equal probability that Canada or the United States will prevail. If the CDSOA was repealed at the beginning of fiscal year 2006, the savings relative to CBO's baseline would total $4.2 billion through 2015.

The President also proposes leasing the coastal plain of the Arctic National Wildlife Refuge for oil and gas development. Under that proposal, the state of Alaska would receive half of the proceeds from bonus bids, rents, and royalties. CBO anticipates that those leases would be offered in two phases (as specified in recent legislative proposals), with the first sale likely to occur in 2008 and the second in 2010. Proceeds to the federal government from the bonuses, rents, and royalties would total $5.2 billion over the 2006-2015 period, CBO estimates, and half of that sum would be paid to the state of Alaska.

Policy Proposals That Affect Discretionary Spending

Discretionary budget authority for the current year totals $840 billion, including $11.5 billion in supplemental appropriations for disaster relief enacted in October 2004. That total will rise to $922 billion if the supplemental budget authority of $82 billion that was recently requested, chiefly for military operations in Iraq, is enacted.

The President's budget proposes $843 billion in discretionary budget authority for 2006, CBO estimates—$439 billion for national defense and $404 billion for nondefense programs (see Table 1-5).[7] However, those totals include no additional appropriations in 2006 for operations in Iraq or Afghanistan.

With proposed and enacted supplemental appropriations for 2005 excluded, discretionary budget authority would grow by 1.7 percent, or roughly $14 billion, between 2005 and 2006 under the President's budget, CBO estimates. Defense funding would increase by about 4.4 percent, but nondefense funding would fall by 1.0 percent.

Discretionary outlays would total $962 billion in 2005 and shrink to $947 billion in 2006, CBO estimates—assuming that no additional funding was provided for operations in Iraq and Afghanistan beyond the amount proposed for 2005 in the President's budget (see Table 1-6). Additional funding to maintain those operations in 2006 at about the level expected for 2005 would add some $40 billion to 2006 outlays, raising them to about $990 billion, CBO projects.

Proposals for Defense Spending

CBO estimates that the President's proposals for defense would increase outlays by $31 billion in 2005, $139 billion over the 2006-2010 period, and $336 billion over the 2006-2015 period relative to CBO's baseline projections. Those increases would result both from supplemental funding requested for 2005 and from increases in regular funding (relative to the baseline) requested for 2006 and later years.

Defense outlays would rise in 2005 because the Administration has requested $75 billion in supplemental budget authority for that year (most of the $82 billion supplemental appropriation mentioned above), primarily for costs associated with military activities in Iraq. If that supplemental funding is enacted, it will also add about $28 billion to defense outlays in 2006 and smaller amounts in subsequent years.

The Administration's proposals for defense spending for 2006 through 2010 exceed the amounts in CBO's baseline, even though they do not include any further fund-

7. For a number of reasons (including different projections of offsetting collections and of the effect of changes to mandatory programs proposed in appropriation bills), the Administration estimates that total budget authority for 2006 will be about $2.7 billion lower than CBO's figure.

Table 1-5.

CBO's Estimate of the President's Proposed Changes in Discretionary Budget Authority, 2004 to 2006

(Billions of dollars)

	Actual	Administration's Request		Percentage Change	
	2004	2005[a]	2006	2004-2005	2005-2006
Budget Authority					
Defense	486	497	439	2.3	-11.7
Nondefense					
Homeland security[b]	27	31	29	11.9	-4.9
Other	394	394	375	0.1	-4.9
Subtotal, nondefense	421	425	404	0.9	-4.9
Total	**907**	**922**	**843**	**1.6**	**-8.6**
Budget Authority Excluding Supplementals[c]					
Defense	394	421	439	6.8	4.4
Nondefense					
Homeland security[b]	27	31	29	12.3	-4.9
Other	368	377	375	2.4	-0.7
Subtotal, nondefense	396	408	404	3.1	-1.0
Total Excluding Supplementals	**789**	**829**	**843**	**4.9**	**1.7**

Source: Congressional Budget Office.

a. The numbers in the top half of this column include the Administration's request for supplemental appropriations to fund activities in Iraq and Afghanistan and for other purposes. CBO assumed that none of that funding was classified as being for homeland security.

b. The amounts shown here reflect net spending for homeland security activities. (About $3 billion to $4 billion in spending per year is offset by fees and other receipts.) CBO's classification of homeland security funding is based on designations established by the Administration. Those designations are not limited to the activities of the Department of Homeland Security. In fact, some of the department's activities (such as disaster relief) are not included in the definition, whereas nondepartmental activities (such as some defense-related programs and some funding for the National Institutes of Health) fall within the Administration's definition of homeland security. About half of all spending considered to be for homeland security is for activities outside the Department of Homeland Security.

c. Supplemental appropriations in 2004, mainly for activities in Iraq and Afghanistan, totaled $117 billion. Supplemental funding of $11.5 billion has been provided thus far in 2005 for hurricane disaster assistance. The President has requested $82 billion in additional supplemental funding—mostly for activities in Iraq—but those appropriations have not yet been enacted.

ing for operations in Iraq and Afghanistan.[8] The amount of budget authority requested for 2006, $439 billion, is $7 billion higher than CBO's baseline level. That difference grows in subsequent years, reaching $36 billion, or 7.0 percent, by 2010. Consequently, outlays from the President's proposals would exceed baseline levels by a total of $139 billion through 2010. With the Administration's request for 2010 funding extrapolated through 2015, outlays from those proposals would total $336 billion more than the baseline over the 2006-2015 period.

Proposals for Nondefense Discretionary Spending

The President's budget proposes cutting budget authority for nondefense discretionary activities by 1.0 percent in 2006 from this year's level (not counting supplemental appropriations). For 2007 through 2010, the President's budget would essentially freeze nondefense discretionary spending other than that for homeland security.

Although most homeland security activities would receive increases in budget authority, total homeland security

8. Pursuant to the rules that govern baseline projections, the baseline excludes funding for operations in Iraq and Afghanistan because no funds have yet been appropriated for those activities for the current year.

Table 1-6.

Discretionary Spending Under the President's Budget and in CBO's March Baseline

(Billions of dollars)

	Actual 2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
						CBO's Estimate of Discretionary Spending Under the President's Budget[a]								
Budget Authority														
Defense	486	497	439	463	481	501	511	524	538	551	566	580	2,395	5,154
Nondefense														
Homeland security[b]	27	31	29	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other	394	394	375	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Subtotal, nondefense	421	425	404	403	406	410	409	418	428	438	448	458	2,032	4,222
Total	**907**	**922**	**843**	**866**	**887**	**911**	**920**	**943**	**966**	**989**	**1,013**	**1,038**	**4,427**	**9,376**
Outlays														
Defense	454	495	472	457	468	486	503	522	526	544	558	572	2,387	5,108
Nondefense														
Homeland security[b]	23	26	28	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other	417	441	446	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Subtotal, nondefense	440	467	474	468	463	463	465	471	480	490	500	510	2,334	4,785
Total	**894**	**962**	**947**	**926**	**931**	**949**	**968**	**993**	**1,006**	**1,033**	**1,057**	**1,083**	**4,721**	**9,893**
						CBO's March 2005 Baseline for Discretionary Spending								
Budget Authority														
Defense	486	422	432	442	453	464	475	487	499	511	524	537	2,266	4,826
Nondefense														
Homeland security[b]	27	31	29	29	30	33	31	32	33	34	34	35	152	320
Other	394	388	398	407	417	427	436	447	457	468	479	490	2,085	4,424
Subtotal, nondefense	421	418	427	437	447	459	468	479	490	501	513	525	2,237	4,744
Total	**907**	**840**	**859**	**879**	**900**	**923**	**943**	**966**	**989**	**1,013**	**1,037**	**1,062**	**4,503**	**9,570**
Outlays														
Defense	454	464	438	435	448	458	469	484	489	505	517	530	2,248	4,773
Nondefense														
Homeland security[b]	23	26	29	30	31	31	31	32	33	33	34	35	152	319
Other	417	440	448	455	463	471	480	490	500	512	524	535	2,316	4,878
Subtotal, nondefense	440	466	477	485	493	502	511	522	533	545	558	570	2,468	5,197
Total	**894**	**930**	**915**	**921**	**941**	**960**	**980**	**1,006**	**1,022**	**1,050**	**1,075**	**1,100**	**4,716**	**9,970**

Continued

funding would drop by $1.5 billion (4.9 percent) from the 2005 level because of two changes. First, Project BioShield, which received appropriations of $2.5 billion for 2005, would not receive additional funding in 2006 under the President's budget. Second, a proposed increase in fees charged by the Transportation Security Administration would boost offsetting collections by about $1.7 billion in 2006.

In all, nondefense discretionary budget authority would decline by roughly $4 billion in 2006 from the 2005 level (excluding supplemental appropriations) under the President's budget, with reductions occurring in several budget functions (see Table 1-7). For example, appropriations for natural resource and environmental programs would drop by $2.5 billion, reflecting cuts in aid to states and Native American tribes and cuts in programs to pre-

Table 1-6.

Continued

(Billions of dollars)

	Actual 2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
							Difference (President's budget minus baseline)							
Budget Authority														
Defense	0	75	7	21	28	37	36	37	38	40	41	43	128	328
Nondefense														
Homeland security[b]	0	*	*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other	0	7	-23	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Subtotal, nondefense	0	7	-23	-33	-41	-50	-58	-60	-62	-64	-65	-67	-204	-522
Total	**0**	**82**	**-16**	**-13**	**-13**	**-13**	**-22**	**-23**	**-23**	**-24**	**-24**	**-24**	**-76**	**-194**
Outlays														
Defense	0	31	34	22	20	28	34	37	38	39	40	42	139	336
Nondefense														
Homeland security[b]	0	*	-1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other	0	1	-2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Subtotal, nondefense	0	1	-2	-17	-30	-39	-46	-51	-54	-56	-58	-60	-134	-412
Total	**0**	**32**	**32**	**5**	**-10**	**-11**	**-12**	**-14**	**-16**	**-17**	**-17**	**-18**	**5**	**-77**

Source: Congressional Budget Office.

Notes: n.a. = not applicable; * = between -$500 million and $500 million.

Discretionary outlays derive from both budget authority and obligation limitations. Spending from the Highway Trust Fund and the Airport and Airway Trust Fund is subject to such limitations. Budget authority for those programs is provided in authorizing legislation and is not considered discretionary.

a. The President's budget specifies total discretionary spending only through 2010. Discretionary spending after 2010 under the President's budget is projected by CBO using its baseline rates of inflation.

b. The amounts shown here reflect net spending for homeland security activities. (About $3 billion to $4 billion in spending per year is offset by fees and other receipts.) CBO's classification of homeland security funding is based on designations established by the Administration. Those designations are not limited to the activities of the Department of Homeland Security. In fact, some of the department's activities (such as disaster relief) are not included in the definition, whereas nondepartmental activities (such as some defense-related programs and some funding for the National Institutes of Health) fall within the Administration's definition of homeland security. About half of all spending considered to be for homeland security is for activities outside the Department of Homeland Security.

vent or fight fires on public and private lands. Discretionary health programs would have their funding reduced by about $3.4 billion in 2006. Much of that decline results from the absence of funding for Project BioShield in 2006, although reductions for the Health Resources and Services Administration (a $767 million cut) and the Centers for Disease Control and Prevention (a $556 million cut) have also been requested.

Some areas of the budget would receive funding increases in 2006 under the President's proposals. International affairs would see the largest rise—$3.8 billion (12.8 percent), with roughly $1.5 billion of that increase allocated to the Millennium Challenge Corporation. Medicare would receive an increase of $1.1 billion in discretionary funding in 2006, mainly for the costs of administering the new Part D prescription drug program.

Policy Proposals That Affect Revenues

The President's budget proposes several changes to tax law that would reduce revenues significantly over the next decade relative to the amounts that CBO and JCT estimate would be collected under current law. Such proposals include the extension of a number of expiring tax provisions and a variety of new tax incentives. The most

Table 1-7.

Comparison of Discretionary Budget Authority Enacted for 2005 and Requested by the President for 2006, by Budget Function

(Billions of dollars)

	2005 Enacted[a]				Change, 2005-2006[b]	
	Total	Disaster Relief Supplemental	Total Excluding Supplemental	2006 Request	Billions of Dollars	Percent
Defense Discretionary	421.6	1.1	420.6	439.0	18.4	4.4
Nondefense Discretionary						
International affairs	30.0	0.1	29.9	33.8	3.8	12.8
General science, space, and technology	24.3	0.1	24.2	24.6	0.4	1.8
Energy	3.8	0	3.8	4.5	0.7	19.1
Natural resources and environment	31.3	0.9	30.4	28.0	-2.5	-8.1
Agriculture	5.7	0	5.7	5.4	-0.4	-6.3
Commerce and housing credit[c]	1.8	*	1.8	0.9	-1.0	-53.1
Transportation	25.3	1.3	24.0	21.6	-2.4	-10.1
Community and regional development	22.7	7.7	14.9	12.6	-2.4	-15.9
Education, training, employment, and social services	79.6	0	79.6	78.1	-1.5	-1.8
Health	54.4	0.1	54.3	50.9	-3.4	-6.3
Medicare (Administrative costs)	4.0	0	4.0	5.1	1.1	26.5
Income security	46.1	*	46.0	47.3	1.2	2.6
Social Security (Administrative costs)	4.4	0	4.4	4.7	0.3	7.0
Veterans' benefits and services	30.9	0.1	30.7	31.4	0.7	2.3
Administration of justice	38.7	*	38.7	38.8	0.1	0.4
General government	15.4	0.1	15.3	16.4	1.1	7.2
Allowances for emergencies and other needs	0	0	0	*	*	n.a.
Subtotal, nondefense discretionary	418.4	10.4	408.0	404.0	-4.0	-1.0
Total	**840.0**	**11.5**	**828.6**	**843.0**	**14.4**	**1.7**
Memorandum:						
Transportation Obligation Limitations[d]	45.3	0	45.3	45.7	0.4	0.8

Source: Congressional Budget Office.

Note: * = between -$50 million and $50 million; n.a. = not applicable.

a. Excludes $82 billion in supplemental appropriations, mostly for activities in Iraq, that have been proposed but not yet enacted.

b. Excludes supplemental appropriations for disaster relief enacted in 2005.

c. Includes certain receipts (such as those from loan guarantees made by the Federal Housing Administration's Mutual Mortgage Insurance program) and other collections (such as those from the Securities and Exchange Commission) that are recorded as negative budget authority and outlays.

d. Spending from the Highway Trust Fund and the Airport and Airway Trust Fund is provided through obligation limitations. Budget authority for those programs is provided in authorizing legislation and is not considered discretionary.

significant changes include those involving provisions of EGTRRA and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), the research and experimentation tax credit, deductions for certain premiums paid for health care plans with high deductibles, tax-free savings accounts, and tax credits for developers of affordable housing. CBO and JCT estimate that, as a whole, the Administration's proposals would reduce revenues by $3 billion in 2006 and by $1.4 trillion over the 2006-2015 period (see Table 1-3 on page 4). As discussed above, the proposals' effects on refundable tax credits would also increase outlays by roughly $120 billion over those 10 years.

Permanent Extensions of EGTRRA and JGTRRA Provisions

The Administration proposes to permanently extend various provisions of EGTRRA and JGTRRA that are scheduled to expire in coming years. Those provisions include changes in income tax rates, relief from the so-called marriage penalty, an increase in the child tax credit, provisions related to education and retirement, and repeal of the estate tax. The implementation of those provisions was accelerated by JGTRRA, which directed that they take effect earlier than they would have done under EGTRRA. Extending those provisions rather than letting them expire as scheduled would reduce revenues by just over $1 trillion through 2015.

The President's budget also proposes extending the lower rates on capital gains and dividends that are scheduled under JGTRRA to rise at the end of 2008. Making those rates permanent would reduce revenues by an additional $148 billion between 2006 and 2015, CBO and JCT project.

Another provision of JGTRRA and the American Jobs Creation Act of 2004 liberalized the rules governing depreciation for small businesses from 2003 through 2007, mainly by increasing the amount of investment that such businesses could expense (that is, deduct from their taxable income immediately rather than over time) from $25,000 to $100,000. The President's budget would make those expensing changes permanent, at a cost of about $19 billion between 2006 and 2015.

In total, the proposals in the 2006 budget to make permanent various extensions and accelerations of tax provisions would reduce revenues by an estimated $1.2 trillion (and increase outlays by $62 billion) through 2015.

Research and Experimentation Tax Credit

Under current law, corporations can obtain a tax credit of 20 percent on certain research expenditures above a base amount. The credit is scheduled to expire on December 31, 2005, but the President's budget proposes to make it permanent. That proposal would reduce projected revenues by a total of $78 billion over the next 10 years, according to CBO and JCT.

"Above-the-Line" Deduction for High-Deductible Health Insurance

Currently, people who buy individual (not employment-based) health insurance plans with a high deductible that must be met before reimbursement will occur can contribute to health savings accounts, which can be used to pay their and their dependents' health care costs. The Administration proposes allowing people who contribute to health savings accounts to deduct from their taxable income the premiums they pay for individually purchased, high-deductible plans.[9] The deduction would be used in calculating adjusted gross income (AGI) and would be allowed even if taxpayers did not itemize deductions. (Taxpayers who itemize deductions can deduct medical expenses exceeding 7.5 percent of AGI from their taxable income.) If that proposal took effect on January 1, 2006, as envisioned, it would cost an estimated $33 billion over the 2006-2015 period.

Refundable Tax Credit for Health Insurance

Another of the President's proposed policies for 2006 is the creation of a refundable income tax credit for the cost of health insurance. The credit, which would also take effect on January 1, 2006, would be worth as much as $1,000 per adult and $500 per child (for up to two children). It could cover a maximum of 90 percent of the cost of insurance for single taxpayers with a maximum modified AGI of $15,000; those with higher income would receive less, and the credit would phase out completely for single taxpayers with a modified AGI of $30,000. (The maximum AGI would be higher for families.) That credit would reduce revenues by a total of $12 billion and raise outlays by $52 billion over the 2006-2015 period.

Expansion of Tax-Free Savings Accounts

The tax code contains a variety of tax-favored savings plans, which are used primarily for retirement but also for

9. The Administration did not provide specific information about what kinds of plans would qualify as high-deductible health insurance.

other purposes, such as education. The President proposes to unify many of those accounts into two tax-favored savings vehicles—retirement savings accounts (RSAs) and lifetime savings accounts (LSAs)—and to expand their scope. For RSAs, individuals could contribute up to $5,000 annually, and no income limits would apply. Contributions would not be deductible, but all earnings on the accounts would accumulate tax-free. Tax- and penalty-free withdrawals could occur after age 58 or because of death or disability. Accounts currently held as Roth individual retirement accounts (IRAs) would become RSAs. No further contributions to traditional IRAs would be allowed, but such accounts could be converted into RSAs in the same way that they can now be converted into Roth IRAs.

In addition, individuals could contribute up to $5,000 annually to lifetime savings accounts, which would face the same tax treatment as RSAs and, like them, have no income restrictions on participation. In contrast to the treatment that applies to IRA withdrawals, however, withdrawals from LSAs could be made for any purpose and at any age. Balances currently held in Coverdell education savings accounts and qualified state tuition plans could be converted into balances in LSAs.

On net, those proposals would reduce revenues by $2 billion over the 2006-2015 period, CBO and JCT estimate. Revenues would increase from 2006 to 2010 as new contributions were directed away from current savings plans that receive an immediate tax deduction and toward the new vehicles, which would not. In addition, some taxpayers would convert their existing traditional IRAs to RSAs, generating more revenue in the first four years. As a result, the proposals would increase federal revenues when the contributions were made and the balances converted but would reduce revenues later (from 2011 to 2015) when withdrawals went untaxed.

Tax Credit for Developers of Affordable Housing

Another proposal in the President's budget would provide a tax credit to developers of affordable single-family housing sold to buyers with income below a certain level. Starting in 2006, state and local housing credit agencies would be given authority to award credits to developers of some single-family housing in places with median income that was no more than 80 percent of the area's median income or in places with chronic economic problems. Developers would receive the credit only if a home's buyer had an income no higher than 80 percent of median family income. The credit would lower revenues by an estimated $17 billion over 10 years.

Other Revenue Proposals

The President's budget contains a number of other tax changes, such as incentives related to charitable giving, health care, education, and the environment. It also includes various changes in tax law related to pensions and other retirement saving, incentives to increase energy production or encourage energy conservation, and extensions of a number of provisions scheduled to expire at the end of 2005. Together, those other proposed changes would reduce revenues by $55 billion and increase outlays by $7 billion over the 2006-2015 period.

CBO's and the Administration's Economic Assumptions

CBO and the Administration are forecasting similar values for the underlying economic variables used to estimate revenues and outlays. On the whole, however, the Administration's economic forecast implies higher projections of revenues, slightly higher projections of outlays, and a more favorable outlook for the budget. Those differences in economic assumptions add about $55 billion to CBO's estimate of the cumulative deficit for the 2006-2010 period under the President's budget.

CBO projects slightly higher growth of real (inflation-adjusted) GDP than the Administration does for most of those five years (see Table 1-8 on page 18). However, CBO's projection of the nominal level of GDP between 2006 and 2010 is lower than the Administration's by roughly $325 billion, or 0.5 percent. That lower projection for nominal GDP is reflected in lower projections for wages and salaries, which reduce projected receipts from individual income and social insurance taxes.

In addition, the Administration projects that wages and salaries—the category of income with the largest effect on revenue projections—will make up a larger share of GDP during the 2006-2010 period than CBO does. For later years in that projection period, Administration's slightly higher level of nominal GDP also tends to keep the projected level of wages and salaries above that in CBO's projection.

Compared with CBO, the Administration projects higher inflation through 2010 (as measured by the consumer price index for all urban consumers) and generally lower

interest rates (although its projection of rates on 10-year Treasury notes is higher beginning in 2009). The slightly higher inflation projection coupled with the higher projection of 10-year interest rates causes the Administration to estimate greater outlays under the President's budget after 2008 than CBO does. The inflation measures that CBO uses to estimate cost-of-living adjustments for Social Security and other programs are the same as the Administration's in 2006 but slightly lower thereafter. However, CBO projects a higher percentage increase in the consumer price index for food consumed at home—which is used to estimate the maximum Food Stamp benefit—in 2006 (differences are minimal thereafter). The Administration's projections of short- and long-term interest rates are generally lower than CBO's, resulting in lower projected costs for servicing federal debt held by the public.

Differences Between CBO's and the Administration's Budget Estimates

Overall, the cumulative deficits projected by CBO and the Administration for the 2006-2010 period under the President's budget differ by only $57 billion—equivalent to 0.4 percent of projected outlays in that period. That difference results because CBO estimates lower outlays from the President's proposals than the Administration does, largely for technical reasons. To a lesser extent, CBO and JCT also estimate lower revenues under the President's budget, mainly because of differences in economic assumptions. Most of the differences between the two projections relate to the baseline estimates.

CBO's Baseline Versus the Administration's Current-Services Baseline

In the current-services baseline published with the President's budget, the Administration projects a deficit of $390 billion for 2005, whereas CBO's baseline projects a deficit of $365 billion (neither of those estimates includes any additional funding for military operations in Iraq and Afghanistan). Thereafter, the Administration projects that the deficit will decline each year from 2006 through 2010, with the cumulative shortfall totaling about $1.35 trillion. CBO's baseline anticipates the same trend and projects a deficit of $1.23 trillion for that five-year period (see Table 1-9 on page 20).

As was the case last year, the two baselines reflect some conceptual differences. CBO constructs its baseline as specified by the Balanced Budget and Emergency Deficit Control Act of 1985. The Administration, however, has deviated from prior practices in three ways. First, its baseline assumes that the major tax-law changes enacted in EGTRRA and JGTRRA will be extended. Second, it has not extrapolated into future years the $11.5 billion in supplemental appropriations provided for disaster relief for 2005. And third, it has adjusted the way in which it accounts for increases in pay when projecting discretionary spending. As a result, some differences between the two baselines can be attributed to conceptual differences as well as to economic and technical factors.

On the spending side of the budget, CBO's estimate of outlays for 2005 is $21 billion below the Administration's. Almost all of that difference ($20 billion) results from differences in estimates of mandatory spending—the largest being a $5 billion difference for Medicaid. In terms of discretionary spending, CBO's and the Administration's estimates for 2005 are within about $0.5 billion of each other.

For the 2006-2010 period, CBO's baseline estimate of total outlays is $125 billion lower than that of the Administration. Virtually all of that difference ($121 billion) involves mandatory outlays (excluding debt service). CBO's estimate of Medicare spending over that period is lower than the Administration's by $79 billion, or 3.9 percent, mostly because the Administration projects higher enrollment in and higher costs for Medicare's new prescription drug benefit. In addition, CBO estimates lower spending on veterans' programs over that period than the Administration does (by about $22 billion, or 11.2 percent), mostly because CBO expects lower participation in the veterans' disability compensation program and a smaller average benefit per enrollee. Similarly, CBO's estimate of 2006-2010 outlays for the Food Stamp program falls short of the Administration's by about $20 billion, or 10.6 percent, because of lower projections of participation. Discretionary outlays in CBO's baseline are $11 billion below the Administration's projection for the 2006-2010 period, with almost all of that difference stemming from differing projections of defense spending.

Overall, revenue projections in CBO's latest baseline are very similar to the Administration's current-services projections. CBO expects $5 billion more in revenues than the Administration does in 2005 but a total of $6 billion less in the 2006-2010 period.

Table 1-8.

Comparison of CBO's, the Administration's, and Private-Sector Economic Projections for Calendar Years 2005 to 2010

	Estimated 2004	Forecast 2005	Forecast 2006	Projected Annual Average, 2007-2010
Nominal GDP (Billions of dollars)				
CBO	11,730	12,396	13,059	15,940 [a]
Administration	11,731	12,392	13,083	16,112 [a]
March *Blue Chip*	11,741	12,417	13,089	n.a.
Nominal GDP (Percentage change)				
CBO	6.6	5.7	5.3	5.1
Administration	6.6	5.6	5.6	5.3
March *Blue Chip*	6.6	5.8	5.4	5.3
Real GDP (Percentage change)				
CBO	4.4	3.8	3.7	3.3
Administration	4.4	3.6	3.5	3.2
March *Blue Chip*	4.4	3.7	3.4	3.2
GDP Price Index (Percentage change)				
CBO	2.1	1.8	1.5	1.8
Administration	2.1	1.9	2.0	2.1
March *Blue Chip*	2.1	2.0	2.0	2.1
Consumer Price Index[b] (Percentage change)				
CBO	2.7	2.4	1.9	2.2
Administration	2.7	2.4	2.3	2.4
March *Blue Chip*	2.7	2.5	2.3	2.4
Unemployment Rate (Percent)				
CBO	5.5	5.2	5.2	5.2
Administration	5.5	5.3	5.2	5.1
March *Blue Chip*	5.5	5.2	5.1	5.0

Continued

As noted above, the Administration's baseline assumes that EGTRRA and JGTRRA will be permanently extended beyond their scheduled expirations. In contrast, CBO's baseline does not assume that any of the expiring provisions of those laws will be extended, which increases its revenue projections relative to the Administration's by roughly $53 billion over the five-year period. The expiring provisions whose extension would have the greatest effect on revenues during those years include the amount of expensing allowed for certain small-business investments (which expires at the end of 2007) and the reduced tax rates on capital gains and dividends (which expire at the end of 2008). The revenue effects of extending the provisions in those two laws that are scheduled to expire at the end of 2010 would be quite small over the 2006-2010 period.

That conceptual difference is offset by technical and economic differences between the two baselines—mostly related to assumptions about GDP, inflation, and the amount of tax revenue generated by a given level of income. Those differences lower CBO's revenue projections by $59 billion over the five-year period compared with the Administration's.

Differences Between CBO's and the Administration's Policy Estimates

Overall, CBO's estimates of the impact of the President's proposals on mandatory spending and revenues do not differ much from those of the Administration ($14 billion and $6 billion higher, respectively, for the 2006-2010 period). However, some notable differences exist in estimates of specific proposals.

Table 1-8.

Continued

	Estimated 2004	Forecast 2005	Forecast 2006	Projected Annual Average, 2007-2010
Three-Month Treasury Bill Rate (Percent)				
CBO	1.4	2.8	4.0	4.6
Administration	1.4	2.7	3.5	4.1
March *Blue Chip*	1.4	3.1	3.9	4.2
Ten-Year Treasury Note Rate (Percent)				
CBO	4.3	4.8	5.4	5.5
Administration	4.3	4.6	5.2	5.5
March *Blue Chip*	4.3	4.6	5.2	5.5
Tax Bases[c] (Percentage of GDP)				
Corporate book profits				
CBO	8.4	10.7	9.4	8.7
Administration	8.5	10.5	9.8	8.5
Wages and salaries				
CBO	45.6	45.7	45.8	45.9
Administration	45.6	45.6	45.8	46.3
Tax Bases[c] (Billions of dollars)				
Corporate book profits				
CBO	984	1,331	1,222	1,349 [a]
Administration	998	1,307	1,276	1,292 [a]
Wages and salaries				
CBO	5,346	5,665	5,979	7,317 [a]
Administration	5,345	5,649	5,988	7,502 [a]

Sources: Congressional Budget Office; Office of Management and Budget; Aspen Publishers, Inc., *Blue Chip Economic Indicators* (March 10, 2005); Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board; Department of Labor, Bureau of Labor Statistics.

Note: Percentage changes are year over year. n.a. = not available.

a. Level in 2010.

b. The consumer price index for all urban consumers.

c. The *Blue Chip* survey does not include projections of tax bases.

Differences in Outlays. CBO projects that the President's proposals would decrease mandatory outlays by $26 billion over the 2006-2010 period—roughly $14 billion less than the Administration estimates. Nearly one-third of that difference is attributable to proposals involving Medicaid and the State Children's Health Insurance Program.

The President's budget reports savings of $45 billion through 2015 from legislation that would alter Medicaid and SCHIP. However, CBO estimates that the proposal to enroll more children in Medicaid and SCHIP would be less effective over the 2006-2015 period than the Administration anticipates. In addition, CBO could not estimate savings from several other proposals (dealing with restrictions on certain types of above-cost payments to providers and on payments for various social and rehabilitative services) because the Administration did not provide sufficient details about how the savings would be achieved. (The Administration estimated that those proposals would save $23 billion over the 2006-2015 period). As a result, CBO estimates that the Medicaid and SCHIP proposals in the President's budget would generate only $9 billion in savings between 2006 and 2010—about $4 billion less than the Administration estimates (see Table 1-4 on page 6). Over 10 years, those proposals would save $27 billion, CBO estimates.

Table 1-9.

Comparison of CBO's March 2005 Baseline and the Administration's February 2005 Current-Services Baseline

(Billions of dollars)

	2005	2006	2007	2008	2009	2010	Total, 2006-2010
				CBO's March 2005 Baseline			
Revenues	2,057	2,213	2,357	2,508	2,662	2,807	12,547
On-budget	1,484	1,608	1,719	1,836	1,956	2,066	9,186
Off-budget	573	605	638	672	706	740	3,361
Outlays							
Discretionary	930	915	921	941	960	980	4,716
Mandatory	1,316	1,385	1,456	1,539	1,631	1,724	7,735
Net interest	177	211	248	274	290	304	1,328
Total	2,422	2,511	2,625	2,754	2,881	3,008	13,779
On-budget	2,023	2,095	2,196	2,309	2,419	2,527	11,547
Off-budget	399	416	429	445	462	481	2,232
Deficit (-) or Surplus	-365	-298	-268	-246	-219	-201	-1,232
On-budget	-539	-487	-477	-473	-463	-461	-2,361
Off-budget	175	189	209	227	244	260	1,129
				Administration's February 2005 Current-Services Baseline			
Revenues	2,053	2,178	2,347	2,518	2,668	2,841	12,552
On-budget	1,492	1,585	1,718	1,854	1,967	2,098	9,222
Off-budget	561	593	629	665	701	743	3,331
Outlays							
Discretionary	930	914	923	942	961	986	4,727
Mandatory	1,336	1,416	1,485	1,558	1,645	1,752	7,856
Net interest	177	209	242	269	291	310	1,321
Total	2,443	2,539	2,650	2,770	2,897	3,048	13,903
On-budget	2,044	2,119	2,218	2,323	2,429	2,560	11,650
Off-budget	399	420	432	446	467	488	2,253
Deficit (-) or Surplus	-390	-361	-303	-251	-229	-207	-1,351
On-budget	-552	-534	-500	-469	-462	-462	-2,429
Off-budget	162	173	197	218	233	256	1,078

Continued

Another difference between the Administration's and CBO's outlay estimates involves the refundable portion of the tax credits for certain health expenditures. JCT and CBO project that those proposals would increase outlays by $2 billion more over the 2006-2010 period and by $12 billion more over the 2006-2015 period than the Administration projects.

CBO's estimates of the effects of the President's proposals for student aid are similar in total to the Administration's estimates for the 2005-2010 period but significantly different for the following five years. CBO estimates that the proposals would produce net savings of $0.2 billion between 2005 and 2015; the Administration concludes that they would save $10.1 billion. Estimating differences for specific proposals result from differences in the baselines or from conceptual differences (in the case of the Perkins loan recall and reinsurance payments to guaranty agencies for defaulted loans), from different modeling techniques (which affect the proposed impact of a cap on bor-

Table 1-9.

Continued

(Billions of dollars)

	2005	2006	2007	2008	2009	2010	Total, 2006-2010
			Difference (CBO minus Administration)				
Revenues	5	35	10	-10	-6	-34	-6
On-budget	-8	23	1	-18	-11	-31	-36
Off-budget	12	12	9	7	5	-3	30
Outlays							
Discretionary	-1	1	-2	-2	-2	-6	-11
Mandatory	-20	-31	-29	-19	-14	-28	-121
Net interest	-1	2	6	5	*	-6	7
Total	-21	-28	-25	-16	-16	-40	-125
On-budget	-21	-24	-22	-14	-10	-33	-103
Off-budget	-1	-4	-3	-2	-6	-7	-21
Deficit or Surplus[a]	26	63	35	5	10	6	119
On-budget	13	47	23	-4	-1	2	67
Off-budget	13	16	11	9	11	4	52
Memorandum:							
Deficit Under the Administration's BEA Baseline	-391	-369	-315	-256	-213	-212	-1,364

Sources: Congressional Budget Office; Office of Management and Budget.

Note: * = between -$500 million and zero; BEA = Budget Enforcement Act of 1990.

a. Positive numbers denote that the Administration's deficit estimate is higher than CBO's, and negative numbers denote that the Administration's deficit estimate is lower than CBO's.

rowers' interest rates), and from other estimating assumptions.

Another proposal for which CBO's estimate differs markedly from the Administration's is a proposal to increase the rates that federal power marketing administrations charge for electricity to reflect "market" prices for the sale of power. CBO's estimate of the net additional receipts from that change is about $2.6 billion less over the 2006-2010 period and $10.5 billion less over the 2006-2015 period than the Administration's estimate. That difference has three sources. First, CBO assumes that the proceeds from any increase in rates collected by the Bonneville Power Administration (BPA) would be spent by that agency, in accordance with current law. BPA's operations are financed by a revolving fund, using the proceeds from the sale of electricity and transmission services. CBO assumes that the agency would continue to operate in that manner. Second, CBO assumes that under current law, the other three power marketing administrations (the Southwestern, Southeastern, and Western) would sell power at a weighted average rate of around $30 per megawatt hour. The Administration assumes a much lower rate under current law. Third, CBO estimates a lower "market" rate than the Administration does.

CBO's estimate of savings to the Commodity Credit Corporation over the 2006-2015 period from the President's agriculture proposals is $10 billion lower than the Administration's estimate. Among the reasons, CBO's forecasts of crop and milk prices tend to be lower than the Administration's, especially for the later years of the projection period. Also, CBO incorporates into its estimates the probability of a range of commodity-price forecasts and the possible cost to the government if prices fall below the projected levels. In addition, CBO assumes that the President's proposals for commodity programs (except those affecting dairy programs) would take effect in 2006

because of contractual commitments that are likely to be entered into this year, whereas the Administration assumes that they would take effect in 2005.

In addition, over the 2006-2010 period, CBO assumes roughly $4 billion less in savings than the Administration does from the proposed repeal of the Continued Dumping and Subsidy Offset Act. That difference results from two sources. First, as noted above, CBO assumes a 50 percent probability that the United States will prevail in its current dispute with Canada about duties on Canadian softwood lumber. Second, CBO does not assume that the United States will continue to collect duties on Canadian lumber following the resolution of the dispute. The Administration, by contrast, assumes that the United States will prevail in the case and continue to collect duties on Canadian lumber thereafter and that all of the duties collected will be distributed to the affected domestic industries.

Finally, CBO's estimate of savings from the President's proposal to change funding rules for pensions and alter the PBGC's premium structure exceeds the Administration's estimate by $2.6 billion over five years and $2.4 billion over 10 years. The reason is that CBO interprets the proposal as being intended to achieve a specific level of total premiums. CBO's baseline estimate of premium income is lower than the Administration's, which means that CBO assumes that in reaching the Administration's target, the proposal would generate a larger increase in premium receipts relative to CBO's baseline.

Differences in Revenues. CBO and JCT estimate that the President's budgetary proposals would reduce revenues by a total of about $100 billion over the 2006-2010 period—$6 billion less than the Administration estimates. Compared with the Administration, CBO and JCT project smaller revenue losses in 2008 and 2009 and larger revenue losses in 2006, 2007, and 2010.

The overall revenue difference for the 2006-2010 period stems in large part from the proposals to extend the current tax rates on capital gains and dividends beyond their scheduled expiration (on December 31, 2008). CBO's and JCT's estimate of the degree to which those extensions would reduce revenues is $11 billion less than the Administration's—about $9 billion for the capital gains provision and $2 billion for the dividend provision—and is concentrated in the 2008-2010 period, around the time of expiration. CBO and JCT also estimate $3 billion less in revenue losses than the Administration does from extending the expensing of certain capital investments by small businesses.

Those differences are partially offset by several cases in which CBO and JCT estimate greater revenue losses than the Administration does: adjusting the funding for single-employer pension plans (a $2 billion greater revenue loss through 2010), extending the repeal of the estate tax and modifying gift taxes (a $2 billion greater revenue loss), and extending the research and experimentation tax credit (a $1 billion greater revenue loss). CBO and JCT also estimate a smaller revenue gain through 2010 (by $2 billion) from the proposals to expand tax-free savings accounts.

Changes to CBO's Baseline Since January 2005

In conjunction with its annual analysis of the President's budget, CBO updates the 10-year baseline projections it published in the previous January.[10] Those projections, which are constructed according to rules specified in law, estimate the future path of spending and revenues under the assumption that current laws do not change. As such, the projections are intended to serve as a neutral benchmark against which to measure the budgetary effects of proposed policy changes.

Revisions to CBO's baseline since January have added $125 billion to the cumulative deficit projected for the 2006-2015 period, which now stands at $980 billion (see Table 1-10). The projection of total outlays over that period has increased by $128 billion, offset slightly by an increase of $3 billion in projected revenues (see Table 1-11). Those revisions are almost exclusively technical; legislative changes since January have been minimal, and CBO has not updated its economic assumptions.

Outlays

Much of the change to CBO's outlay projections comes from an increase of $70 billion (or 1.5 percent) in projected spending for Medicare over the 2006-2015 period, partially offset by a decrease of $26 billion (less than 1 percent) in projected spending for Medicaid over that

10. See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015.*

Table 1-10.

CBO's Baseline Budget Projections

	Actual 2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
							In Billions of Dollars							
Revenues														
Individual income taxes	809	899	986	1,082	1,172	1,265	1,362	1,561	1,718	1,822	1,932	2,048	5,867	14,947
Corporate income taxes	189	216	226	226	237	246	249	254	261	270	281	292	1,184	2,542
Social insurance taxes	733	790	833	876	918	962	1,009	1,054	1,102	1,151	1,202	1,253	4,598	10,360
Other	148	153	167	173	181	188	188	193	222	231	243	255	897	2,041
Total	**1,880**	**2,057**	**2,213**	**2,357**	**2,508**	**2,662**	**2,807**	**3,062**	**3,304**	**3,475**	**3,657**	**3,847**	**12,547**	**29,891**
On-budget	1,345	1,484	1,608	1,719	1,836	1,956	2,066	2,288	2,494	2,629	2,775	2,928	9,186	22,301
Off-budget	535	573	605	638	672	706	740	774	809	845	882	919	3,361	7,591
Outlays														
Discretionary spending	894	930	915	921	941	960	980	1,006	1,022	1,050	1,075	1,100	4,716	9,970
Mandatory spending	1,237	1,316	1,385	1,456	1,539	1,631	1,724	1,838	1,908	2,042	2,172	2,317	7,735	18,012
Net interest	160	177	211	248	274	290	304	313	316	314	312	307	1,328	2,890
Total	**2,292**	**2,422**	**2,511**	**2,625**	**2,754**	**2,881**	**3,008**	**3,157**	**3,246**	**3,406**	**3,559**	**3,725**	**13,779**	**30,871**
On-budget	1,913	2,023	2,095	2,196	2,309	2,419	2,527	2,658	2,723	2,855	2,978	3,111	11,547	25,871
Off-budget	380	399	416	429	445	462	481	499	524	551	580	614	2,232	5,000
Deficit (-) or Surplus	**-412**	**-365**	**-298**	**-268**	**-246**	**-219**	**-201**	**-95**	**57**	**69**	**99**	**122**	**-1,232**	**-980**
On-budget	-567	-539	-487	-477	-473	-463	-461	-370	-229	-226	-203	-183	-2,361	-3,571
Off-budget	155	175	189	209	227	244	260	275	286	295	302	305	1,129	2,591
Debt Held by the Public	4,296	4,656	4,965	5,246	5,506	5,737	5,949	6,054	6,004	5,941	5,847	5,726	n.a.	n.a.
Memorandum:														
Gross Domestic Product	11,553	12,233	12,888	13,586	14,307	15,029	15,757	16,494	17,245	18,023	18,826	19,652	71,566	161,806
							As a Percentage of GDP							
Revenues														
Individual income taxes	7.0	7.3	7.7	8.0	8.2	8.4	8.6	9.5	10.0	10.1	10.3	10.4	8.2	9.2
Corporate income taxes	1.6	1.8	1.8	1.7	1.7	1.6	1.6	1.5	1.5	1.5	1.5	1.5	1.7	1.6
Social insurance taxes	6.3	6.5	6.5	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4
Other	1.3	1.3	1.3	1.3	1.3	1.3	1.2	1.2	1.3	1.3	1.3	1.3	1.3	1.3
Total	**16.3**	**16.8**	**17.2**	**17.3**	**17.5**	**17.7**	**17.8**	**18.6**	**19.2**	**19.3**	**19.4**	**19.6**	**17.5**	**18.5**
On-budget	11.6	12.1	12.5	12.7	12.8	13.0	13.1	13.9	14.5	14.6	14.7	14.9	12.8	13.8
Off-budget	4.6	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Outlays														
Discretionary spending	7.7	7.6	7.1	6.8	6.6	6.4	6.2	6.1	5.9	5.8	5.7	5.6	6.6	6.2
Mandatory spending	10.7	10.8	10.7	10.7	10.8	10.9	10.9	11.1	11.1	11.3	11.5	11.8	10.8	11.1
Net interest	1.4	1.4	1.6	1.8	1.9	1.9	1.9	1.9	1.8	1.7	1.7	1.6	1.9	1.8
Total	**19.8**	**19.8**	**19.5**	**19.3**	**19.3**	**19.2**	**19.1**	**19.1**	**18.8**	**18.9**	**18.9**	**19.0**	**19.3**	**19.1**
On-budget	16.6	16.5	16.3	16.2	16.1	16.1	16.0	16.1	15.8	15.8	15.8	15.8	16.1	16.0
Off-budget	3.3	3.3	3.2	3.2	3.1	3.1	3.0	3.0	3.0	3.1	3.1	3.1	3.1	3.1
Deficit (-) or Surplus	**-3.6**	**-3.0**	**-2.3**	**-2.0**	**-1.7**	**-1.5**	**-1.3**	**-0.6**	**0.3**	**0.4**	**0.5**	**0.6**	**-1.7**	**-0.6**
On-budget	-4.9	-4.4	-3.8	-3.5	-3.3	-3.1	-2.9	-2.2	-1.3	-1.3	-1.1	-0.9	-3.3	-2.2
Off-budget	1.3	1.4	1.5	1.5	1.6	1.6	1.6	1.7	1.7	1.6	1.6	1.6	1.6	1.6
Debt Held by the Public	37.2	38.1	38.5	38.6	38.5	38.2	37.8	36.7	34.8	33.0	31.1	29.1	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable.

Table 1-11.

Changes in CBO's Baseline Projections of the Deficit or Surplus Since January 2005

(Billions of dollars)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
Total Deficit (-) or Surplus as Projected in January 2005	-368	-295	-261	-235	-207	-189	-80	71	85	115	141	-1,188	-855
Changes to Revenue Projections													
Legislative	*	*	0	0	0	0	0	0	0	0	0	*	*
Technical	*	*	*	*	*	*	*	*	*	*	*	1	3
Total Revenue Changes	*	*	*	*	*	*	*	*	*	*	*	**1**	**3**
Changes to Outlay Projections													
Technical													
Discretionary	-1	1	1	1	1	*	*	*	*	*	*	3	3
Mandatory													
Medicare	2	2	5	7	6	5	7	6	8	11	13	25	70
Medicaid	-2	-3	-3	-2	-2	-2	-2	-2	-3	-4	-4	-11	-26
Social Security	*	1	1	1	2	2	2	2	3	3	3	6	19
Veterans' compensation	*	*	1	1	1	1	2	2	2	2	3	4	14
Student loans	0	1	1	1	1	1	1	1	1	1	1	5	10
Other	-1	4	2	3	2	3	3	4	3	*	-1	14	23
Subtotal, mandatory	-1	5	7	11	10	11	13	12	14	13	14	43	110
Net interest	-1	-2	-1	*	1	1	2	2	3	3	5	*	15
Total Outlay Changes	**-3**	**4**	**7**	**11**	**12**	**12**	**15**	**14**	**17**	**16**	**19**	**46**	**128**
Total Impact on the Deficit or Surplus	**3**	**-3**	**-7**	**-11**	**-12**	**-12**	**-15**	**-14**	**-16**	**-16**	**-19**	**-44**	**-125**
Total Deficit (-) or Surplus as Projected in March 2005	-365	-298	-268	-246	-219	-201	-95	57	69	99	122	-1,232	-980

Source: Congressional Budget Office.

Note: * = between -$500 million and $500 million.

period. CBO has made technical changes to its baseline for Medicare to reflect revised estimates of the cost of the prescription drug program. Those revisions result from changes in CBO's estimating methods and from the fact that various final rules issued for the program differ from what CBO had anticipated on the basis of legislative language. (For more details, see Appendix A.) For those reasons, CBO now expects the prescription drug program to cost $54 billion more through 2015 than it projected in January (with about $36 billion of that increase expected through 2013, the time frame covered by CBO's original estimate of the cost of the Medicare Modernization Act). A little more than half of the increase involves estimates of the net cost of basic benefits; the rest involves estimates of the cost of the program's subsidy for low-income beneficiaries.

For the Medicaid program, revisions to CBO's baseline projections were fueled by a number of factors, such as the continuing efforts of states to control spending for the program, updated data from the Centers for Medicare and Medicaid Services, and slower growth in the number of people receiving Supplemental Security Income benefits (who are automatically eligible for Medicaid). CBO now projects that Medicaid spending will grow at an

average annual rate of 7.8 percent from 2006 to 2015, compared with 8.2 percent in the January baseline.

CBO has also increased its estimate of Social Security outlays over the 10-year projection period by $19 billion, chiefly to reflect a change in its projections of retroactive benefits in the Old-Age and Survivors Insurance program. Retroactive benefits, which go primarily to new beneficiaries, reflect a recomputation of benefits to incorporate final earnings or lump-sum payments to compensate for processing time.

CBO has raised its projection of spending for veterans' disability compensation over the 2006-2015 period by $14 billion because of new information from the Department of Veterans Affairs about the average disability rating of veterans who join the disability-compensation rolls. CBO has changed the average disability rating assumed for those new recipients to 40 percent from roughly 30 percent in the previous baseline.

Finally, CBO has added about $1 billion per year to its projection of outlays for student loans, for a total increase of $10 billion over the 2006-2015 period. New data indicate higher loan volumes than CBO anticipated in the January baseline. In addition, CBO now expects lower premiums to be charged to borrowers because it assumes that fewer guaranty agencies will change their premiums to meet minimum reserve requirements.

Revenues

CBO's revenue projections have not changed significantly since January. CBO has raised its baseline projection of revenues for each year of the 2006-2015 period by less than $500 million, for a total increase of about $3 billion over that period. The rise mainly reflects slightly higher projections of receipts from miscellaneous fees and fines, especially the fees that finance the Universal Service Fund (which supports certain telephone and telecommunications services).

In addition to such technical changes, a small legislative change enacted since CBO completed its previous baseline has affected revenue projections. Public Law 109-1 allows taxpayers to deduct from their income in 2004 any charitable cash contributions they made in January 2005 for the relief of victims of the Indian Ocean tsunami. That law will reduce revenues by $11 million in 2005 and raise them by $9 million in 2006, JCT estimates.

Net Interest

As a result of revisions to the baseline that increase projected revenues and outlays, CBO now estimates that the Treasury would need to borrow more if current laws did not change than it would have had to under the January baseline. By CBO's estimate, such additional borrowing and other technical adjustments would raise net interest payments on federal debt by a total of $15 billion over the 2006-2015 period.

CHAPTER

2

The Economy Under the President's Budget and Under CBO's Baseline Policy Assumptions

In analyzing the President's budgetary proposals for 2006, the Congressional Budget Office considered how those policies—in comparison with the policies incorporated in CBO's baseline—would affect the economy. CBO concluded that under the policies in the President's budget, economic output would probably be slightly lower, on average, over the 2006-2010 period but somewhat higher over the 2011-2015 period than it would be under the policies in CBO's baseline. However, CBO's analysis suggests that the differences are likely to be small, affecting output by an average of less than one-half of 1 percent over the full 10-year period.

The small size of the effects on output stems in part from the small magnitude—relative to the overall economy—of the proposals' budgetary impact. For example, in CBO's estimation, revenues from 2006 to 2010 under the President's proposals—excluding economic effects—would be lower by 0.14 percent of cumulative gross domestic product than they would be under CBO's baseline. Spending, including interest on government debt, would be higher by 0.01 percent of GDP. Moreover, various proposals in the budget have offsetting effects: some tend to imply greater output, and some tend to imply less.

The macroeconomic effects of the proposals could in turn alter their budgetary cost. Under CBO's economic assumptions, the President's budgetary proposals would increase the cumulative deficit for the 2006-2010 period, CBO estimates, by $104 billion (0.1 percent of cumulative GDP), compared with the deficit under the baseline's policy assumptions. If the budgetary effects of the economic changes resulting from those proposals were included in the estimate, the projected increase in the cumulative deficit over that period would range from as much as $165 billion to as little as $105 billion (see Figure 2-1 and Table 2-1).

For the years 2011 to 2015, the President's proposals, as assessed using the baseline's economic assumptions, would increase the cumulative deficit by $1,497 billion (1.7 percent of cumulative GDP). If the budgetary effects of the economic changes resulting from those proposals were also considered, the projected increase in the cumulative deficit over that period would range from as much as $1,523 billion to as little as $1,366 billion.

How Fiscal Policy Affects the Economy

Budgetary policies can affect the economy in a variety of ways. Changes in the tax rates that people face on their income can affect incentives to work and save; government spending on goods and services can reduce the resources available for investment; and spending and tax policies can influence the overall level of demand in the economy.[1] Those factors and other possible economic influences can be broadly divided into long-run supply-side effects and short-run demand-side effects.

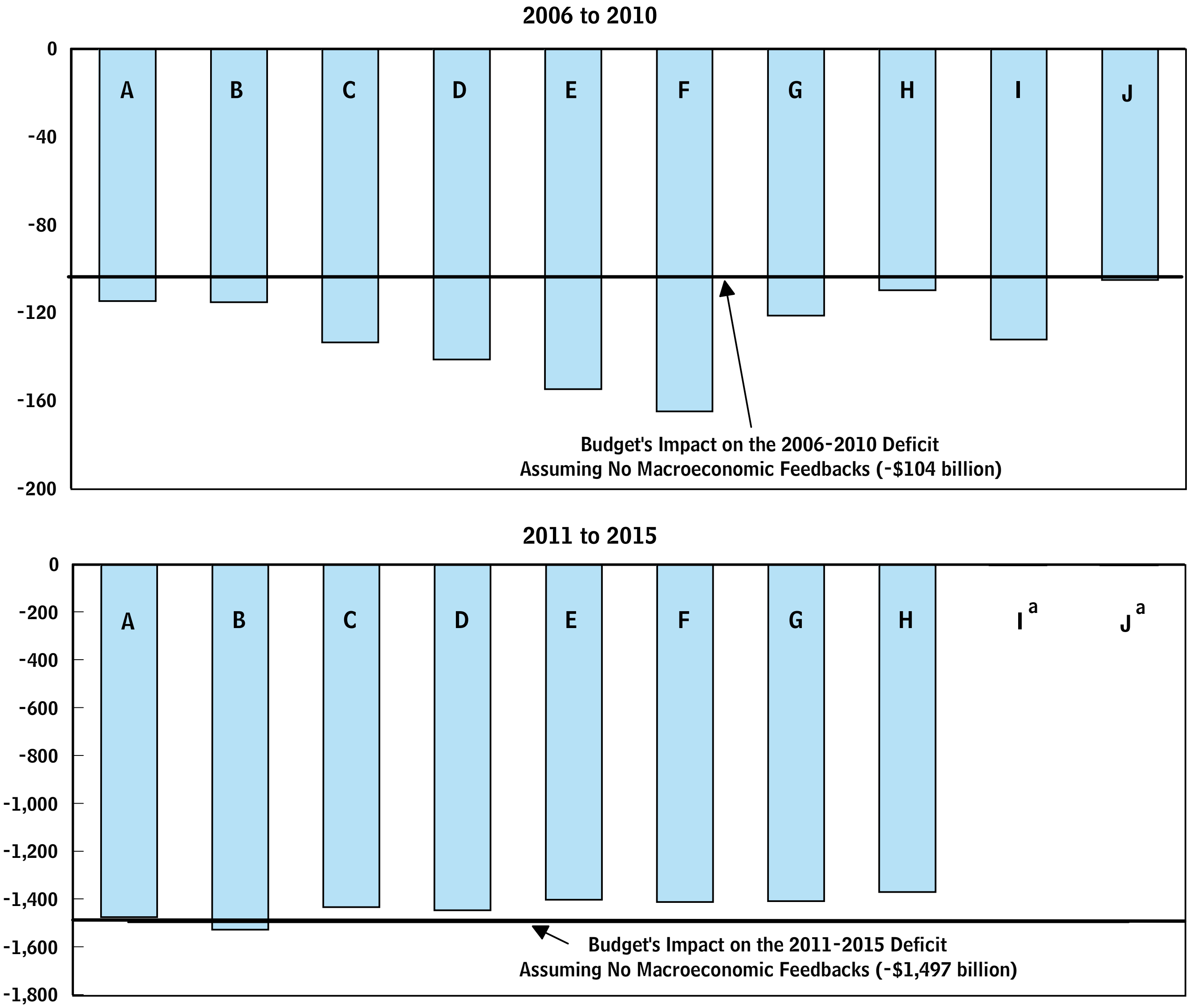
The economy's underlying potential to produce goods and services depends on the size and quality of both the labor force and the stock of productive capital (such as factories and information systems) as well as on the level of technological know-how. Analysts refer to long-term changes in those three determinants of potential output

1. Analysts refer to government outlays for current goods and services (as opposed to outlays for transfer payments, interest on government debt, or long-lasting investments, such as highways or military equipment) as government "consumption," because it reduces the resources available for investment in much the same way that private consumption does.

Figure 2-1.

CBO's Estimates, Using Various Models, of How the President's Budget Would Affect the Deficit After Accounting for Economic Effects

(Cumulative change from CBO's baseline, in billions of dollars)



Source: Congressional Budget Office.

Notes: The estimates in the figure reflect the proposals' supply-side effects on the economy but exclude demand-side economic impacts, as explained in the text. A negative change indicates an increase in the cumulative deficit relative to CBO's baseline.

CBO's analysis used the following models (which are described in the text): (A) "textbook" high model, (B) "textbook" low model, (C) closed-economy life-cycle model with lower government spending after 2015, (D) closed-economy life-cycle model with higher taxes after 2015, (E) open-economy life-cycle model with lower government spending after 2015, (F) open-economy life-cycle model with higher taxes after 2015, (G) infinite-horizon model with lower government consumption after 2015, (H) infinite-horizon model with higher taxes after 2015, (I) Macroeconomic Advisers' model, and (J) Global Insight's model.

a. Because this model is designed primarily to capture business-cycle developments, which are hard to predict beyond a few years, CBO did not compute an estimate for the 2011-2015 period.

Table 2-1.

CBO's Estimates of How the President's Budget Would Affect the Deficit After Accounting for Economic Effects

(Cumulative change from CBO's baseline, in billions of dollars)

	2006 to 2010	2011 to 2015
Growth Models		
Without Forward-Looking Behavior		
Textbook Model		
High (Hours worked respond strongly to tax-rate changes)	-114	-1,472
Low (Hours worked respond weakly to tax-rate changes)	-115	-1,523
With Forward-Looking Behavior		
Closed-Economy Life-Cycle Model		
Lower government spending after 2015	-133	-1,430
Higher taxes after 2015	-141	-1,443
Open-Economy Life-Cycle Model		
Lower government spending after 2015	-154	-1,399
Higher taxes after 2015	-165	-1,408
Infinite-Horizon Model		
Lower government spending after 2015	-121	-1,405
Higher taxes after 2015	-109	-1,366
Macroeconometric Models		
Supply-Side Contribution		
Macroeconomic Advisers	-132	n.a.
Global Insight	-105	n.a.
Supply-Side and Demand-Side Contributions		
Macroeconomic Advisers	-109	n.a.
Global Insight	-105	n.a.
Memorandum:		
CBO's Estimate of the Budgetary Effects of the President's Proposals Under Baseline Economic Assumptions	-104	-1,497

Source: Congressional Budget Office.

Notes: A negative number indicates an increase in the cumulative deficit relative to CBO's baseline.

The "textbook" growth model is an enhanced version of a model developed by Robert Solow. The life-cycle growth model, developed by CBO, is an overlapping-generations general-equilibrium model. The infinite-horizon growth model is an enhanced version of a model first developed by Frank Ramsey. The models by Macroeconomic Advisers and Global Insight, which are available commercially, are designed to forecast short-term economic developments. The various models reflect a wide range of assumptions about the extent to which people are forward-looking in their behavior: in the textbook model and those by Macroeconomic Advisers and Global Insight, people have the least foresight, whereas in the infinite-horizon model, people's foresight is perfect and extends infinitely to include a full consideration of effects on descendants.

In models with forward-looking behavior, CBO had to make assumptions about how the President's budget would be financed after 2015. CBO chose two alternatives—cutting government consumption and transfer payments or raising marginal tax rates.

n.a. = not applicable.

as supply-side changes because they alter the quantity of goods and services that the economy is capable of supplying on a sustainable basis. Supply-side changes have a lasting effect on the economy.

In the short run, however, economic output can deviate from its potential level, as the total demand for goods and services moves above and below that level, causing employment to rise and fall and the stock of capital to be used more or less intensively. Those movements are referred to as demand-side, or cyclical, variations. Unlike movements on the supply side of the economy, cyclical changes are temporary—built-in corrective forces that usually tend to move the economy back toward the sustainable potential level determined by the supply side.

Both supply-side and demand-side economic developments depend on the choices of millions of individuals about what and how much to buy, how much to save and what assets to hold, and where and how much to work. The government plays a crucial role in establishing the legal and institutional framework within which the economy operates and an overall level of government spending and taxes. Once that general structure is in place, however, changes in government spending and tax policies influence individuals' choices only to a limited degree. Decisions by businesses, personal circumstances, and preferences play a much larger role in economic performance than do modest changes in the federal government's fiscal policies.

Supply-Side Effects

The supply-side effects of the President's budgetary proposals could include influences on the quantity and quality of labor, the size and composition of the capital stock, and technological progress. Changes in any or all of those factors are capable of altering potential output.

The Quantity and Quality of Labor. The overall quantity and quality of labor in the economy is an important determinant of potential output. Put simply, a long-term increase in the overall number of hours worked raises the economy's potential to generate output. Moreover, increases in workers' educational attainment, level of training, and experience or degree of effort on the job raise the quality of each hour worked, which will also increase potential output. Some analysts argue that certain policies in the President's budget—for example, making current tax rates permanent—will ultimately affect the quality of labor. However, the channels through which budgetary policies influence that supply-side variable and the pace at which such effects occur are not well understood. For that reason, CBO's analysis concentrated on the hours of labor supplied, which the President's proposals would affect in two main ways.

First, several provisions, such as the extension of the child tax credit and the exemption from taxation of some dividend and capital gains income, would increase people's after-tax income but not significantly change the marginal tax rates on income resulting from labor. (In general, the marginal rate is the rate on the next dollar of income.) A rise in after-tax income without a change in marginal rates tends to reduce the number of hours of labor that people supply because they can maintain the same standard of living with less work.

Second, some of the President's proposed policies, such as the extension of the marginal tax rates enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001, would both increase the compensation after taxes for each additional hour of work and boost after-tax income overall. Evaluating how that kind of change affects the number of hours people work is complicated by the fact that the policy has opposing effects: people earn more for each extra hour they work, which tends to encourage them to supply more labor, but they can also work fewer hours and earn the same after-tax income, which tends to discourage work. Most studies find that, on balance, reductions in marginal tax rates such as those that the President is proposing will increase the hours of labor supplied, primarily because they will draw secondary earners (for example, the spouse of a household's primary breadwinner) into the labor force.

To summarize as a single number the changes proposed by the President in the schedule of marginal tax rates, CBO estimated the impact that those changes would have on the effective marginal tax rate on labor income—the rate at which the average additional dollar of compensation for labor is taxed (see Table 2-2). The largest changes in rates occur for the years 2011 to 2015, because the President proposes to make permanent various reductions in taxes that are scheduled to expire after 2010. For those years, the average effective marginal tax rate on labor income would be between 4 percent and 5 percent lower under the President's proposals than under the current-law policies incorporated in CBO's baseline.

Table 2-2.

CBO's Estimates of Effective Federal Marginal Tax Rates on Labor Income

(Percent)

Calendar Year	Tax Rate Under Current Law	Tax Rate Under the President's Budget	Difference: Percentage Points	Difference: Percent
2005	26.7	26.7	0	0
2006	27.2	27.2	0	0
2007	27.5	27.5	0	0
2008	27.7	27.7	0	0
2009	28.0	28.0	0	0
2010	28.3	28.3	0	0
2011	30.0	28.6	-1.5	-5.0
2012	30.2	28.8	-1.4	-4.7
2013	30.3	29.0	-1.3	-4.4
2014	30.5	29.2	-1.3	-4.2
2015	30.7	29.4	-1.3	-4.1

Source: Congressional Budget Office.

Note: The effective federal marginal tax rate on income from labor is the share of the last dollar of such income taken by taxes—specifically, federal individual income and payroll taxes.

The President's proposals might also influence the level of the capital stock (discussed in the next section), which could change people's productivity and wages and thus affect the hours of labor supplied. That is, if the proposals reduced investment, the stock of productive capital would be smaller and wages would be lower, which would discourage work. (Increasing investment would imply the opposite results.)

Another way in which the President's proposals could affect the hours worked in the economy would be by changing people's expectations about future policies. Under the President's proposals, the cumulative federal budget deficit over the 2006-2015 period would grow. That rise could lead people to expect that at some time after that period, fiscal policy would have to change to finance the increase in the federal government's interest payments on the money that the government had borrowed to cover the bigger deficit. Either taxes would have to be raised or spending cut.[2]

If people expected to pay more in taxes or to receive fewer services or smaller transfer payments (such as Social Security benefits), they might try to work and save more now so they would have more resources to compensate for the larger burden in the future. In addition, if people expected to face higher tax rates on their income from labor in the future, they might try to work more before the rates went up and then work less when the rates were higher.

But it is difficult to gauge the degree to which such foresight influences people's decisions. Also unclear is the time horizon that people consider in making plans and the future changes in policy that they actually expect. To illustrate the importance of those factors, CBO used various assumptions in its analysis about the extent of people's foresight and the expectations they might have about future policies and assessed the differences in results.

In sum, the President's budgetary proposals would have relatively small effects, on average, on the number of hours worked over the 2006-2010 period, CBO estimates, and those effects could be positive or negative. Over the 2011-2015 period, however—when the reductions in marginal tax rates were largest relative to CBO's baseline policy assumptions—the proposals would probably increase the hours of labor supplied.

The Size and Composition of the Capital Stock. The President's budgetary policies would influence the size of the

2. For some time, the shortfall could be made up by running larger deficits. But the federal government could not follow such an approach indefinitely because the interest costs would compound over time.

capital stock primarily by affecting consumption and therefore investment. The President's proposals would directly alter government consumption of goods and services relative to the level in CBO's baseline. In 2006 and 2007, the proposals imply an increase in consumption relative to the baseline level, which would tend to lessen investment in private capital by reducing the resources available for that purpose. However, from 2008 through 2015, the proposals imply a reduction in government consumption, which would tend to boost private investment.[3]

The President's budgetary policies would also produce offsetting influences on private consumption. The reductions in taxes that the budget proposes would increase after-tax income, which would tend to increase consumption. Other things being equal, a higher level of consumption could crowd out investment in capital goods. But some of the President's tax proposals—for example, extending EGTRRA's marginal income tax rates, extending the tax rates on dividends and capital gains enacted in the Jobs and Growth Tax Relief Reconciliation Act of 2003, and expanding tax-free savings accounts—would tend to reduce consumption during the years that they were in effect. The reason is that the proposals would provide an incentive to save by lowering the effective marginal tax rates on capital income and thus increasing the after-tax rate of return on savings. (Appendix C analyzes in more detail the potential economic effects of the President's proposals for dividend and capital gains taxation, savings accounts, and the estate tax.)

Again, to summarize in one number the effects of the President's proposals on the rate of return on savings, CBO calculated the average effective marginal tax rate on capital income. That calculation was performed under two sets of policy assumptions: one comprising the current-law policies in CBO's baseline and the other, the President's policies (see Table 2-3). In both instances, the estimated effective tax rates were below all but the lowest statutory marginal rate because some capital income (for example, the interest that flows into tax-free savings accounts or pension funds) is not taxed. According to CBO's estimates, during the 2011-2015 period, the effective marginal tax rate on capital income would be about 8½ percent lower under the President's proposals than under the policies in CBO's baseline.

The reductions in taxes on capital income that the President's budget proposes would raise the rate of return on savings and affect consumption in two opposing ways (just as lowering the marginal tax rate on labor income would have opposing effects on the supply of labor). The higher return on savings that the reductions imply would tend to increase saving and reduce current consumption. But the higher return would also increase savers' wealth by boosting their after-tax income, both now and in the future—which would tend to push up their current consumption. On balance, the implications for consumption that higher returns would have could be either positive or negative. The general conclusion that researchers have drawn from empirical data is that the return on savings has a relatively small effect on how much people spend. Nevertheless, to cover other possibilities, CBO included in its analysis a range of assumptions about how the rate of return on savings might affect consumption. Some of CBO's estimates incorporate the assumption that the rate has little or no effect on how much people spend; for other estimates, CBO assumed that increasing the rate of return on savings would reduce consumption—and increase saving—significantly.

Finally, as described earlier, the larger cumulative 10-year deficit under the President's budgetary proposals (larger relative to CBO's baseline estimate) might lead some people to anticipate changes in policy in the future. If people expected higher taxes, smaller transfer payments, or fewer government services in the years to come, they might reduce their spending and build up their savings to compensate for those anticipated policies. CBO used a range of assumptions about those expectations in its analysis. Most of its estimates indicated that, on average, the domestically owned capital stock would be smaller under the policies in the President's budget than under those in CBO's baseline—but the differences were modest. Positive effects on the capital stock were projected only under the most dramatic assumption about foresight—that people care just as much for future generations as they do for

3. Some of the supportive effect on investment of lower government consumption would probably be offset by a decline in the amount of capital flowing into the United States from other countries. However, because most of the returns on those investments accrue to foreigners, a decline in capital inflows would not commensurately reduce the resources available to U.S. firms and consumers in the long run.

Table 2-3.

CBO's Estimates of Effective Federal Marginal Tax Rates on Capital Income

(Percent)

Calendar Year	Tax Rate Under Current Law	Tax Rate Under the President's Budget	Difference: Percentage Points	Difference: Percent
2005	13.8	13.6	-0.3	-1.8
2006	13.8	13.5	-0.3	-2.1
2007	13.8	13.5	-0.3	-2.4
2008	13.7	13.4	-0.4	-2.7
2009	14.1	13.6	-0.5	-3.7
2010	14.2	13.6	-0.6	-4.2
2011	14.9	13.6	-1.3	-8.5
2012	14.9	13.6	-1.3	-8.6
2013	14.9	13.6	-1.3	-8.5
2014	14.9	13.6	-1.3	-8.5
2015	14.9	13.6	-1.3	-8.6

Source: Congressional Budget Office.

Note: The effective federal marginal tax rate on income from capital is the share of the last dollar of such income taken by taxes—specifically, federal individual income and corporate income taxes.

themselves. In effect, if people had a sufficiently long time horizon, they might recognize and counter the deleterious effects of fiscal policy on the formation of capital and thus on future standards of living.

In addition to changes in the level of the capital stock, changes in the mix of different types of capital within that stock can affect potential output. Among the policies in the President's budget, the proposal to extend the tax rates on corporate dividends and capital gains would probably have the biggest effect on the stock's composition because it would lessen the taxation of corporate income and thus encourage a shift of capital from the noncorporate to the corporate sector. Some corporate income is taxed once at the level of the firm, through the corporate income tax, and again at the personal level, through the individual income tax on dividends and capital gains. That tax treatment distorts the way that capital is allocated in the economy because it discourages investment in the corporate sector relative to investment in the housing and noncorporate business sectors. As a result, less capital is held in the corporate sector than is optimal for the economy's efficient operation.

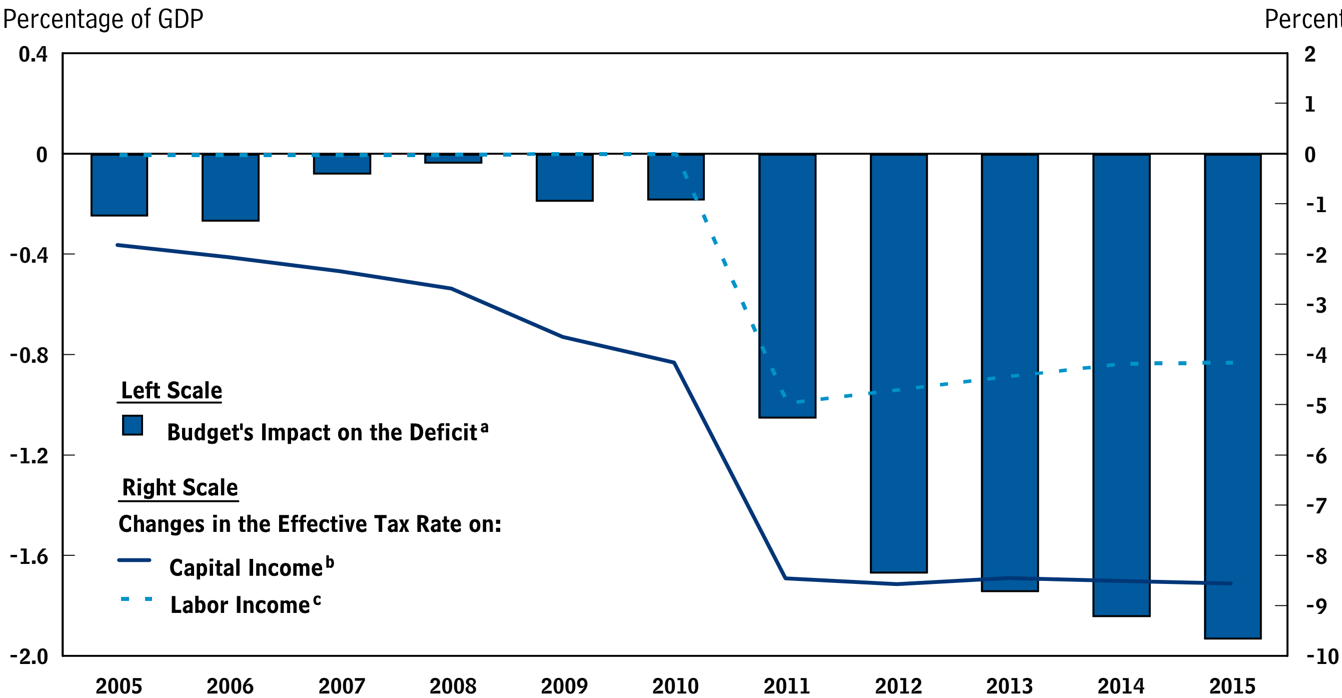
The taxation of dividends and capital gains also encourages firms to finance investment by borrowing rather than by issuing stock. Because firms can deduct their interest payments on debt (for example, bonds they have issued) from their taxable income, they can lessen the tax they pay. (The interest payments will then be taxed only once, at the individual level.) That tax policy may influence firms' decisions about financing and lead to economic inefficiencies. Extending the tax rates on dividends and capital gains would lessen those inefficiencies.

Technological Progress. New and improved technical processes and products are the source of most long-term growth in productivity, and the President's budgetary policies could affect the economy by influencing the rate of such progress. Researchers, however, lack a basis for estimating how fiscal policy influences technological innovation. Because so little is understood about the genesis of that innovation, CBO for the most part has not incorporated in its analysis effects on technological progress arising from the President's proposals.[4]

4. In Global Insight's model, one of two commercial macroeconometric models that CBO used to estimate the demand-related effects of the President's proposals, potential GDP responds positively to spending on research and development—which in turn would be stimulated by the proposal to extend tax credits for research and development. However, the estimated effect on output in the model was very small.

Figure 2-2.

Effects of the President's Budget on the Deficit and on the Effective Tax Rates on Capital Income and Labor Income



Source: Congressional Budget Office.

a. The bars represent the effects of the President's proposals on the budget balance under CBO's baseline economic assumptions. A negative change indicates an increase in the annual deficit relative to CBO's baseline.

b. Changes in the effective federal marginal tax rate on income from capital (the share of the last dollar of such income taken by federal individual income and corporate income taxes).

c. Changes in the effective federal marginal tax rate on income from labor (the share of the last dollar of such income taken by federal individual income and payroll taxes).

Demand-Side (Cyclical) Effects

The federal government's fiscal policies also affect the economy by adding to or subtracting from the total demand for goods and services. Increases in demand can cause firms to temporarily gear up production and hire more workers; decreases in demand can have the opposite effects. From a demand-side perspective, budgetary policies that reduce consumption (and other purchases) might slow the pace of the economy's current cyclical expansion.

Demand-side effects, however, can only temporarily raise or lower output beyond what it would otherwise have been because built-in economic forces tend to move output toward its sustainable potential level. Moreover, policies that increase demand by raising government or private consumption are likely to lower output in the long run because they tend eventually to decrease investment and the size of the capital stock.

A Description of CBO's Models and Their Results

In estimating the economic effects of the President's budgetary proposals relative to its baseline assumptions, CBO used several different economic models that—although similar in some respects—capture different features of the economy and reflect different ways of thinking about it. The models fall into two broad categories. Three estimate only supply-side effects. The other two are commercial macroeconometric models that emphasize the business-cycle aspects of the economy and are designed primarily

to analyze demand-side effects—although they incorporate some supply-side influences as well. (Figure 2-2 presents, year by year, the impact of the President's proposals on effective tax rates on labor and capital and on the deficit—some of the key inputs for CBO's various models. Table 2-4 presents details of CBO's baseline projections of GDP and other economic variables.)

Ten-Year Analysis of Supply-Side Effects

CBO used three growth models—a "textbook" growth model, a life-cycle growth model, and an infinite-horizon growth model—to analyze the supply-side effects of the President's proposals from 2006 through 2015 (the same period that CBO's baseline projections cover). The models differ in part in their assumptions about how far ahead people look in making their plans (see Appendix D). The textbook growth model is not forward-looking—it assumes that people do not explicitly take into account expected future policies in making their current plans. The life-cycle model incorporates the assumption that people make lifelong plans for working and saving but do not take into consideration events that might occur after their death. By contrast, the infinite-horizon model incorporates the assumption that people care as much about the welfare of their descendants as they do about their own welfare. That assumption means that people behave as if they will live forever.

CBO used the textbook growth model to estimate effects under two assumptions about the degree to which people will alter their hours of labor in response to changes in marginal tax rates: a "low" assumption, in which there is little response, and a "high" assumption, in which the response is at the upper end of the consensus of empirical estimates.[5] Under either response assumption, the President's budgetary proposals would have little effect on GDP in the 2006-2010 period. Over the 2011-2015 period, the proposals would reduce GDP by 0.2 percent under the low assumption, in CBO's estimation, and raise GDP by 0.1 percent under the high assumption. Those estimates illustrate the budgetary proposals' opposing effects, as estimated by the textbook growth model: higher deficits crowd out investment, reducing the capital stock, but lower marginal tax rates increase the labor supplied (especially in the last five years of the projection period). Which effect dominates depends on the assumption made about how sensitive the supply of labor is to changes in marginal tax rates.

The textbook growth model's results differ from those of the other two growth models largely because the textbook model does not incorporate forward-looking behavior: people, as it represents them, do not shift hours of labor from the earlier to the later period and do not work and save more in anticipation of policy changes after 2015. In addition, unlike the life-cycle and infinite-horizon models, the textbook growth model does not incorporate any direct effects on private consumption from lower marginal (as opposed to average) tax rates and higher pretax interest rates.

The estimates that CBO produced using the life-cycle and infinite-horizon growth models are based on the assumption that people behave as if they are certain that the assumed budgetary policies—those of the President or of CBO's baseline—will be maintained over the 10-year modeling period. That assumption is an important characteristic of CBO's estimates. In reality, people would probably think it possible that the policies could change at some point during that time.

Another characteristic of the estimates produced by the life-cycle and infinite-horizon models is that they depend in part on how the President's budgetary proposals would affect people's expectations about fiscal policy beyond 2015. Assumptions about those expectations are complicated by the fact that the policies reflected in the baseline are likely to be unsustainable, owing to the extent of both current deficits and projected increases in spending for health and retirement programs.[6] However, CBO assumed that people already expect that the fiscal imbalances under current-law policies will be resolved, though in some unspecified way. In projections using its forward-looking models, CBO made explicit assumptions only about the way in which increases in deficits under the President's budgetary proposals, relative to the baseline, would eventually be financed—not about the way that deficits projected in the baseline would be addressed.

The life-cycle and infinite-horizon models each generated two sets of estimates based on different assumptions about that financing (the models require such an assumption about financing because they are forward-looking).

5. See Congressional Budget Office, *Labor Supply and Taxes* (January 1996).

6. See Congressional Budget Office, *The Long-Term Budget Outlook* (December 2003).

Table 2-4.

CBO's Year-by-Year Forecast and Projections for Fiscal Years 2005 Through 2015

	Estimated	Forecast		Projected								
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Nominal GDP (Billions of dollars)	11,553	12,233	12,888	13,586	14,307	15,029	15,757	16,494	17,245	18,023	18,826	19,652
Nominal GDP (Percentage change)	6.6	5.9	5.4	5.4	5.3	5.0	4.8	4.7	4.6	4.5	4.5	4.4
Real GDP (Percentage change)	4.6	3.8	3.7	3.8	3.5	3.2	3.0	2.8	2.7	2.7	2.6	2.6
GDP Price Index (Percentage change)	1.9	2.0	1.6	1.6	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Consumer Price Index[a] (Percentage change)	2.3	2.8	1.9	2.1	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Employment Cost Index[b] (Percentage change)	2.7	3.1	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Unemployment Rate (Percent)	5.6	5.3	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Three-Month Treasury Bill Rate (Percent)	1.1	2.4	3.8	4.5	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Ten-Year Treasury Note Rate (Percent)	4.3	4.6	5.3	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5
Tax Bases (Billions of dollars)												
Corporate book profits	970	1,257	1,247	1,223	1,264	1,311	1,342	1,378	1,426	1,483	1,549	1,614
Wages and salaries	5,279	5,584	5,900	6,225	6,562	6,898	7,233	7,570	7,912	8,265	8,629	9,002
Tax Bases (Percentage of GDP)												
Corporate book profits	8.4	10.3	9.7	9.0	8.8	8.7	8.5	8.4	8.3	8.2	8.2	8.2
Wages and salaries	45.7	45.7	45.8	45.8	45.9	45.9	45.9	45.9	45.9	45.9	45.8	45.8

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: Percentage change is year over year.

a. The consumer price index for all urban consumers.

b. The employment cost index for wages and salaries only, private-industry workers.

Under one assumption, people believe that the proposals will be financed by gradually reducing government spending on goods and services and on transfer payments (as shares of GDP) over the 2016-2025 period. (The reductions in the two categories would be proportional to their shares of government spending in CBO's baseline.) Under the other assumption, people believe that the proposals will be financed by gradually increasing marginal tax rates over the same period.

The life-cycle model projects that under the President's proposals, GDP will fall by between 0.2 percent and 0.4 percent over the 2006-2010 period relative to CBO's baseline and will rise by between 0.3 percent and 0.8 percent over the 2011-2015 period. Again, the difference between the projected effects over the two periods stems partly from the assumption that people will shift some hours of work from the earlier to the later period, when tax rates will be lower (relative to those assumed in CBO's baseline).

However, in the projections that incorporate the assumption of an open economy, the higher deficits under the President's proposals would attract net inflows of capital from the rest of the world. That means that people in other countries would have increasing claims on the output produced in the United States—that is, on GDP. An alternative measure of output, gross national product (GNP), measures the output produced by labor and capital supplied by U.S. residents, regardless of where those factors of production are located. That measure by definition nets out those increased foreign claims—that is, the capital income that nonresidents earn from their investments in the United States. CBO estimates that under the President's proposals, GNP will fall by about 0.4 percent over the 2006-2010 period relative to CBO's baseline and will rise by between 0.1 percent and 0.2 percent over the 2011-2015 period.

Depending on which of the assumptions is used and on whether the economy is assumed to be open or closed to flows of foreign capital, the infinite-horizon model projects that the President's proposals will subtract (relative to CBO's baseline) between zero and 0.1 percent from GDP during the first five years of the period but then add between 0.5 percent and 0.7 percent during the second five years (see Table 2-5). The difference in projected effects arises partly because people are estimated to shift some of their hours of work from the first five-year span to the second.

The effects on the economy from the President's proposed changes in fiscal policy would in turn affect the federal budget (see Tables 2-1 and 2-6). Using the economic assumptions incorporated in its baseline, CBO projects that the President's proposals will expand the cumulative deficit over the 2006-2010 period by $104 billion. Under the various assumptions used in the growth models that CBO employed in its analysis, the economic effects of the President's proposals over that period could further increase the deficit by $6 billion to $61 billion.

For the 2011-2015 period, the President's budgetary policies are projected to boost the cumulative deficit by $1,497 billion under the baseline's economic assumptions. The economic effects of the President's proposals over that period, according to the models, could add as much as $26 billion to that increase or subtract as much as $131 billion from it.

Five-Year Analysis Including Demand-Side Effects

CBO turned to macroeconometric forecasting models created by two private forecasting firms—Macroeconomic Advisers and Global Insight—to analyze both the demand-side and supply-side effects of the President's budgetary proposals on the economy over the next five years. Although the models include embedded growth models, their design concentrates on demand-side (cyclical) economic effects. Such effects are increasingly harder to estimate as the projections extend further. Therefore, CBO used those models to produce estimates only for the first five years of the 2006-2015 projection period.

Like the textbook growth model, Macroeconomic Advisers' and Global Insight's models are not forward-looking—people, as the models represent them, do not behave as though they have specific expectations about future policies or economic developments. Instead, people respond to economic changes in the same way as they have in the past, regardless of the source of those changes. For example, they react to the tax proposals in the President's budget (which would boost disposable income) by increasing their purchases to about the same degree as they have, on average, in the past when disposable income rose. However, in reality, people might increase their spending by a smaller amount in response to a change in taxes than they would in response to some other change that expanded their income (such as an increase in productivity), because they might feel that tax legislation was more likely to be reversed in the future.

Table 2-5.

CBO's Estimates of How the President's Budget Would Affect Real Gross Domestic Product

(Average percentage change from CBO's baseline)

	2006 to 2010	2011 to 2015
Growth Models		
Without Forward-Looking Behavior		
Textbook Model		
High (Hours worked respond strongly to tax-rate changes)	*	0.1
Low (Hours worked respond weakly to tax-rate changes)	*	-0.2
With Forward-Looking Behavior		
Closed-Economy Life-Cycle Model		
Lower government spending after 2015	-0.2	0.4
Higher taxes after 2015	-0.2	0.3
Open-Economy Life-Cycle Model		
Lower government spending after 2015	-0.3	0.8
Higher taxes after 2015	-0.4	0.8
Memorandum:		
Gross National Product		
Open-Economy Life-Cycle Model		
Lower government spending after 2015	-0.4	0.2
Higher taxes after 2015	-0.4	0.1
Infinite-Horizon Model		
Lower government spending after 2015	-0.1	0.5
Higher taxes after 2015	*	0.7
Macroeconometric Models		
Supply-Side Contribution		
Macroeconomic Advisers	-0.2	n.a.
Global Insight	-0.1	n.a.
Supply-Side and Demand-Side Contributions		
Macroeconomic Advisers	*	n.a.
Global Insight	*	n.a.

Source: Congressional Budget Office.

Notes: The "textbook" growth model is an enhanced version of a model developed by Robert Solow. The life-cycle growth model, developed by CBO, is an overlapping-generations general-equilibrium model. The infinite-horizon growth model is an enhanced version of a model first developed by Frank Ramsey. The models by Macroeconomic Advisers and Global Insight, which are available commercially, are designed to forecast short-term economic developments. The various models reflect a wide range of assumptions about the extent to which people are forward-looking in their behavior: in the textbook model and those by Macroeconomic Advisers and Global Insight, people have the least foresight, whereas in the infinite-horizon model, people's foresight is perfect and extends infinitely to include a full consideration of effects on descendants.

In models with forward-looking behavior, CBO had to make assumptions about how the President's budget would be financed after 2015. CBO chose two alternatives—cutting government consumption and transfer payments or raising marginal tax rates.

* = -0.05 and 0.05 percent; n.a. = not applicable

Table 2-6.

The Budgetary Implications of the Macroeconomic Effects

(Cumulative change from CBO's estimate of the President's budget, in billions of dollars)

	2006 to 2010	2011 to 2015
Growth Models		
Without Forward-Looking Behavior		
Textbook Model		
High (Hours worked respond strongly to tax-rate changes)	-11	25
Low (Hours worked respond weakly to tax-rate changes)	-11	-26
With Forward-Looking Behavior		
Closed-Economy Life-Cycle Model		
Lower government spending after 2015	-29	68
Higher taxes after 2015	-37	55
Open-Economy Life-Cycle Model		
Lower government spending after 2015	-51	99
Higher taxes after 2015	-61	89
Infinite-Horizon Model		
Lower government spending after 2015	-17	92
Higher taxes after 2015	-6	131
Macroeconometric Models		
Supply-Side Contribution		
Macroeconomic Advisers	-28	n.a.
Global Insight	-1	n.a.
Supply-Side and Demand-Side Contributions		
Macroeconomic Advisers	-5	n.a.
Global Insight	-1	n.a.

Source: Congressional Budget Office.

Notes: Numbers in this table reflect the effects on the cumulative deficit (relative to CBO's baseline) of the economic impacts shown in Table 2-4. (Negative numbers indicate an increase in the deficit; positive numbers, a reduction.) They do not include the estimated cost of the President's budgetary proposals under CBO's baseline economic assumptions. The total impact of the proposals on the cumulative deficit, including both those direct costs and the secondary effects shown above, appear in Table 2-1.

The "textbook" growth model is an enhanced version of a model developed by Robert Solow. The life-cycle growth model, developed by CBO, is an overlapping-generations general-equilibrium model. The infinite-horizon growth model is an enhanced version of a model first developed by Frank Ramsey. The models by Macroeconomic Advisers and Global Insight, which are available commercially, are designed to forecast short-term economic developments. The various models reflect a wide range of assumptions about the extent to which people are forward-looking in their behavior: in the textbook model and those by Macroeconomic Advisers and Global Insight, people have the least foresight, whereas in the infinite-horizon model, people's foresight is perfect and extends infinitely to include a full consideration of effects on descendants.

In models with forward-looking behavior, CBO had to make assumptions about how the President's budget would be financed after 2015. CBO chose two alternatives—cutting government consumption and transfers or raising marginal tax rates.

n.a. = not applicable.

The lack of forward-looking behavior in the macroeconometric models implies that specific policy changes that are scheduled to occur in the future do not affect the current behavior of people represented in the models unless special adjustments are made to mimic such behavior. For example, the President's proposal to extend many of the provisions in EGTRRA would reduce taxes from 2011 to 2015 compared with the levels in CBO's baseline. Those lower taxes would increase the amount of after-tax income that people expected in the future, which might cause them to boost their spending today (as the forward-looking models imply). In the macroeconometric models, however, those changes in taxes affect consumption only when they occur.

The projections by Macroeconomic Advisers' and Global Insight's models also required an adjustment to the supply of labor. Like the textbook growth model, those models do not incorporate the effects of taxes on the number of hours worked. Therefore, CBO adjusted the models' equations to incorporate its own estimates of those effects.[7]

Two sets of estimates were produced to illustrate the magnitude of demand-side effects in the models. For one set, CBO ran the models using the standard assumption that monetary policy would allow both demand- and supply-side effects. For the second set, CBO attempted to isolate the supply-side effects by altering interest rates in such a way as to hold the unemployment rate at the level projected in CBO's baseline. That approach produced an estimate of the implications of the proposals for potential (noncyclical) GDP.[8]

Macroeconomic Advisers' model and Global Insight's model differed in their estimates of the effects of the policies in the President's budget relative to the policies in CBO's baseline (see Table 2-5). However, both models predicted that together, the demand- and supply-side effects of those changes would have little effect on GDP, on average, between 2006 and 2010. Also similar were the models' estimates of the supply-side impacts of the President's proposals. Both macroeconometric models projected that the supply-side effects of the President's budgetary policies would decrease output by between 0.1 percent and 0.2 percent.

The projected economic impacts of the proposals would in turn affect the budget. According to the projections from Macroeconomic Advisers' model, the proposals' impact on the economy could add $5 billion to the $104 billion increase in the deficit projected for the 2006-2010 period under the baseline's economic assumptions (see Table 2-6). By the estimates of Global Insight's model, the supply-side and cyclical effects of the President's proposals could add $1 billion to the deficit over the same period.

7. Using data from a large sample of taxpayers, CBO's estimates accounted for the effects of changes in both marginal tax rates and after-tax income under the President's proposals by incorporating a larger response to changes in marginal tax rates among secondary earners than among primary earners.

8. Because the resulting changes in interest rates stem mostly from demand-side effects and the Federal Reserve's efforts to offset them, using those changes in interest rates to calculate budgetary effects ascribed to the supply side makes little sense. Instead, in its estimates of those effects in Tables 2-1 and 2-6, CBO used changes in interest rates that reflected only the predicted changes in the marginal product of capital (the amount produced by one additional unit of capital)—which is the true supply-side effect.

APPENDIX

A

Changes in CBO's Projections of Medicare Spending for 2005 to 2015

As part of the process of updating its projections of Medicare spending for the March 2005 baseline, the Congressional Budget Office (CBO) reviewed the final rules recently published for the prescription drug (Part D) and Medicare Advantage programs, analyzed new data relevant to those activities, and refined its estimating methods. On the basis of those analyses, CBO now projects that net mandatory spending for Medicare will grow from $290 billion in 2005 to $649 billion in 2015 and will total just over $5 trillion for the 2005-2015 period. In January 2005, CBO projected that net mandatory spending for Medicare would grow from $287 billion in 2005 to $636 billion in 2015, totaling just under $5 trillion for the same period. The new projection for net mandatory spending over the period is $72 billion (1.5 percent) higher than CBO's January projection (see Table A-1).[1]

That increase of $72 billion in projected Medicare spending comprises a $2.4 billion rise in 2005 and a boost of $70 billion over the 2006-2015 period. The increase of $2.4 billion projected for 2005 is attributable to spending in the first five months of the fiscal year that has grown more rapidly than CBO anticipated in January 2005. Information on which components of the program are responsible for that unexpectedly rapid growth is not yet available.

Revised projections for two programs account for most of the estimated $70 billion change over the 2006-2015 period. CBO's projection of net mandatory Medicare spending for the prescription drug benefit under Part D is $54 billion higher than its January estimate. A revision in projected spending for the regional preferred provider organization (PPO) component of the Medicare Advantage program accounts for $6 billion of the 10-year increase.

Medicare's Prescription Drug Benefit

CBO projects that net mandatory Medicare spending for Part D will total $851 billion over the 2005-2015 period, or $54 billion more than CBO's projection in January 2005. (Box A-1 on page 44 compares CBO's current projection of Part D spending with its original estimate of the program's cost covering the 2004-2013 period.) The changes in CBO's new projection of Part D spending through 2015 fall into three broad categories:

- An increase of $12 billion in the net cost of the basic benefit, which reflects provisions in the final rule that differ from those CBO had anticipated in its original estimate;[2]
- An increase of $19 billion in the net cost of the basic benefit resulting from the use of new data and other refinements of CBO's estimating methodology; and
- An increase of $23 billion in the cost of the low-income subsidy and transitional drug assistance.

1. All of the revisions in CBO's projections of Medicare spending are "technical" changes—that is, there has been no change in CBO's economic projections since the completion of the January 2005 baseline, nor has legislation been enacted that would affect CBO's projections of Medicare spending.

2. The Part D program, as discussed here, has two main parts: the basic benefit and the low-income subsidy. The basic benefit portion comprises payments to participating prescription drug plans (including employer- or union-sponsored plans and Medicare Advantage plans) for the federal share of spending below the initial benefit limit or above the catastrophic threshold. Net spending for the basic benefit also includes receipts from premiums. Spending for the low-income subsidy represents payments for transitional assistance and the cost-sharing obligations of participants in the low-income subsidy program (as well as the mandatory administrative costs of that program).

Table A-1.

Comparison of CBO's March 2005 and January 2005 Baseline Projections of Medicare Mandatory Spending

(By fiscal year, in billions of dollars)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2005-2010	Total, 2005-2015
	March 2005 Baseline Projections of Medicare Mandatory Spending												
Benefits													
Part A	177.8	182.4	194.2	203.8	215.5	228.4	246.0	253.8	274.6	292.4	312.2	1,202	2,581
Part B	145.9	149.5	159.4	166.6	175.9	187.7	205.9	215.9	238.7	258.9	280.6	985	2,185
Part D													
Basic benefits	0	35.7	57.7	66.5	72.7	81.0	89.0	99.5	110.6	124.8	140.1	314	878
Low-income subsidy and transitional assistance	1.1	9.0	15.2	17.7	19.9	22.1	24.4	27.3	30.5	34.3	38.5	85	240
Subtotal, Part D	1.1	44.7	72.9	84.2	92.6	103.1	113.4	126.8	141.1	159.1	178.7	399	1,118
Subtotal, benefits	324.7	376.6	426.4	454.6	483.9	519.2	565.3	596.5	654.4	710.4	771.5	2,586	5,884
Other Mandatory	2.7	1.9	1.6	1.6	1.6	1.6	1.7	1.7	1.7	1.7	1.7	11	20
Subtotal, gross mandatory	327.5	378.6	428.0	456.2	485.5	520.9	566.9	598.1	656.1	712.2	773.2	2,597	5,903
Offsetting Receipts													
Premiums for Parts A and B	-37.9	-40.4	-42.9	-45.5	-48.4	-52.6	-57.8	-61.9	-67.9	-74.6	-81.9	-268	-612
Premiums for Part D	0	-6.0	-9.0	-10.5	-11.5	-12.9	-14.3	-16.3	-18.3	-21.0	-23.8	-50	-144
Payments by states for Part D	0	-6.0	-9.0	-9.9	-10.8	-11.8	-12.7	-13.9	-15.2	-16.6	-18.0	-48	-124
Subtotal, offsetting receipts	-37.9	-52.5	-60.8	-65.9	-70.7	-77.3	-84.8	-92.0	-101.4	-112.2	-123.8	-365	-879
Total, Net Mandatory	**289.6**	**326.1**	**367.2**	**390.4**	**414.9**	**443.5**	**482.1**	**506.1**	**554.7**	**599.9**	**649.4**	**2,232**	**5,024**
	January 2005 Baseline Projections of Medicare Mandatory Spending												
Benefits													
Part A	176.9	182.4	192.6	202.7	214.5	227.2	243.8	252.7	272.5	290.0	308.5	1,196	2,564
Part B	144.7	148.7	157.1	163.9	175.2	189.3	207.9	219.5	241.1	260.7	282.0	979	2,190
Part D													
Basic benefits	0	38.0	56.9	63.8	69.4	76.3	83.3	92.7	103.2	115.5	129.3	304	829
Low-income subsidy and transitional assistance[a]	0.8	6.6	14.3	16.6	18.6	20.6	22.7	25.1	28.1	31.6	35.4	77	220
Subtotal, Part D	0.8	44.6	71.3	80.4	88.0	97.0	106.0	117.8	131.3	147.1	164.7	382	1,049
Subtotal, benefits	322.3	375.7	420.9	446.9	477.6	513.5	557.8	590.1	644.9	697.8	755.3	2,557	5,803
Other Mandatory	2.7	1.6	1.6	1.6	1.6	1.6	1.7	1.7	1.7	1.7	1.8	11	19
Subtotal, gross mandatory	325.0	377.3	422.5	448.5	479.2	515.1	559.4	591.7	646.6	699.5	757.0	2,568	5,822
Offsetting Receipts													
Premiums for Parts A and B	-37.9	-40.4	-42.4	-44.8	-48.5	-53.3	-58.5	-63.5	-69.1	-75.7	-83.1	-267	-617
Premiums for Part D[a]	0	-6.8	-9.0	-10.0	-10.8	-11.9	-12.9	-14.4	-16.0	-17.9	-20.0	-48	-130
Payments by states for Part D	0	-5.7	-9.1	-10.1	-10.9	-11.8	-12.7	-13.8	-15.1	-16.5	-17.8	-48	-124
Subtotal, offsetting receipts	-37.9	-52.9	-60.5	-64.9	-70.2	-76.9	-84.1	-91.7	-100.2	-110.1	-120.9	-363	-870
Total, Net Mandatory	**287.2**	**324.4**	**362.0**	**383.7**	**409.0**	**438.2**	**475.3**	**500.1**	**546.4**	**589.4**	**636.2**	**2,204**	**4,952**

Continued

Table A-1.

Continued

(By fiscal year, in billions of dollars)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2005-2010	Total, 2005-2015
	Difference (March minus January)												
Benefits													
Part A	1.0	**	1.6	1.1	1.0	1.2	2.2	1.0	2.1	2.5	3.7	6	17
Part B	1.2	0.8	2.3	2.7	0.7	-1.5	-2.1	-3.6	-2.4	-1.9	-1.4	6	-5
Part D													
Basic benefits	0	-2.3	0.8	2.7	3.3	4.7	5.6	6.8	7.3	9.3	10.8	9	49
Low-income subsidy and transitional assistance[a]	0.3	2.5	0.8	1.1	1.3	1.5	1.7	2.2	2.4	2.8	3.1	7	20
Subtotal, Part D	0.3	0.1	1.6	3.8	4.6	6.1	7.4	9.0	9.8	12.1	14.0	17	69
Subtotal, benefits	2.4	0.9	5.5	7.7	6.3	5.8	7.5	6.4	9.5	12.7	16.2	29	81
Other Mandatory	0	0.4	0	0	0	0	0	0	0	0	0	*	*
Subtotal, gross mandatory	2.4	1.3	5.5	7.7	6.3	5.8	7.5	6.4	9.5	12.7	16.1	29	81
Offsetting Receipts													
Premiums for Parts A and B	0	0	-0.5	-0.7	0.1	0.6	0.7	1.6	1.2	1.1	1.2	0	5
Premiums for Part D[a]	0	0.8	0.1	-0.4	-0.7	-1.1	-1.4	-1.9	-2.3	-3.1	-3.8	-1	-14
Payments by states for Part D	0	-0.4	0.2	0.1	0.1	**	**	-0.1	-0.1	-0.1	-0.3	0	0
Subtotal, offsetting receipts	0	0.4	-0.3	-1.0	-0.5	-0.4	-0.7	-0.3	-1.1	-2.1	-2.9	-2	-9
Total, Net Mandatory	**2.4**	**1.7**	**5.2**	**6.7**	**5.8**	**5.4**	**6.8**	**6.0**	**8.3**	**10.5**	**13.2**	**27**	**72**

Source: Congressional Budget Office.

Notes: Medicare Part A is the Hospital Insurance component of the program, Part B is Supplementary Medical Insurance, and Part D is the prescription drug benefit.

More details on CBO's March 2005 baseline projections for Medicare are available at www.cbo.gov/factsheets/2005/Medicare.pdf.

* = between -$500 million and $500 million; ** = between -$50 million and $50 million.

a. Prior to the March 2005 baseline, CBO presented premiums paid by the low-income subsidy program both as outlays by that program and as receipts (in the Part D premium line). The Administration presents outlays for the low-income subsidy net of the premium payments. To conform to how spending will be reported in the future, CBO has adopted that presentation for the March 2005 baseline. The amounts in this table for the January 2005 baseline have also been adjusted to show spending for the low-income subsidy net of premium payments. That change in presentation has no effect on the estimate of net Medicare spending in the January 2005 baseline or on the differences between the two baselines in projections of net Medicare spending.

Changes Deriving from the Final Rule for the Basic Benefit

In preparing its estimate of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Medicare Modernization Act), CBO made numerous assumptions about how the legislative language would be implemented and how decisions about implementation would affect federal spending. Most of those assumptions were either confirmed by the final rule for the Medicare prescription drug program that was issued on January 28, 2005, or, if an assumption differed from the rule, the change was judged not to have a substantial effect on CBO's projections of spending.

One of CBO's original assumptions, however—regarding the formulary requirements that plans must satisfy to be approved for participation in the Part D program—differs from the guidance in the final rule, resulting in an increase of $12 billion in CBO's projection of net federal spending for the basic benefit over the 2006-2015 period. CBO had assumed that, in general, plans would be permitted to establish restrictive formularies to manage

Box A-1.

Comparing CBO's March 2005 Projection of Medicare Part D Spending with Its Original Estimate of the Program's Cost

In November 2003, the Congressional Budget Office (CBO) estimated that the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Medicare Modernization Act) would result in additional direct spending of about $395 billion over the 2004-2013 period. That figure, the net outcome of a number of different types of expenditures and receipts stemming from the legislation, included an estimated $552 billion in mandatory spending for Medicare Part D—$771 billion in payments for benefits and mandatory administrative costs offset by $219 billion in premiums paid by beneficiaries and payments by states. (The states' payments represent part of their share of the savings from shifting some Medicaid spending for prescription drugs to Medicare.) Those costs were further offset by net savings of almost $13 billion from changes to Parts A and B of Medicare (Hospital Insurance and Supplementary Medical Insurance, respectively) and estimated savings of almost $145 billion from lower spending by Medicaid and other federal programs (largely from shifting some of their spending for prescription drugs to Medicare).

Since enactment of the Medicare Modernization Act, CBO's baselines have included explicit projections of Medicare spending for the Part D program (the $552 billion component of the original estimate). CBO's baseline projections for Parts A and B of Medicare and for Medicaid and other federal health programs incorporate the law's effects on those programs' spending. However, those effects—the $157 billion of offsetting savings in the original estimate—are not readily identifiable, and CBO does not project them separately.

Net Medicare spending for the Part D program over the 2004-2013 period, CBO now projects, will total $593 billion—$41 billion more than its original estimate of $552 billion.[1] That increase results from:

- Slightly higher inflation in CBO's current economic projections, a change incorporated in its January 2005 baseline ($5 billion);
- Provisions in the final rule for the basic Part D benefit that differ from those CBO had anticipated in the original estimate ($8 billion);
- The use of new data as well as other refinements in CBO's method for estimating the net cost of the basic benefit ($11 billion); and
- More-current data on the characteristics of Medicare beneficiaries, the final rule governing eligibility for the low-income subsidy, and other revisions in the cost of the low-income subsidy and transitional drug assistance ($17 billion).

CBO does not separately project the offsetting savings that Medicaid and other federal programs accrue from shifting some prescription drug spending to Medicare. Those savings, however, are likely to be larger than CBO's original estimate of $145 billion—both because of CBO's projection of higher inflation and because its current estimate of the number of Medicare beneficiaries who are enrolled in Medicaid is larger than its previous projection. Thus, CBO projects that over the 2004-2013 period, the increase (relative to CBO's original estimate) in the cost of establishing the Part D program will probably be less than $41 billion.

1. See the Congressional Budget Office's letter to the Honorable Joe Barton regarding updated estimates of spending for the Medicare prescription drug program (March 4, 2005), available at www.cbo.gov/ftpdocs/61xx/doc6139/03-04-BartonMedicare.pdf.

spending. However, the guidance regarding the formulary makes it clear that the Secretary of Health and Human Services will rely heavily on a comparison of a plan's proposed formulary with "industry best practices" in deciding whether to approve the plan's application. As a result, CBO now expects that prescription drug plans will be slightly less effective in controlling drug spending than it had previously assumed.

Changes from Methodological Refinements

In the two years that have passed since its original estimate of the Part D benefit, CBO has reviewed and refined the methods it used in that analysis and incorporated survey and program data that have become available. As a result, CBO has revised its estimate of how much plans will incur in administrative costs. That change increased the projection of net federal spending for the basic benefit by $20 billion over the 2006-2015 period.

CBO has also made several other revisions to its projections of spending for the basic benefit. On the basis of information furnished by sponsors of retiree health benefits, it has reduced its projection of the number of beneficiaries who will be covered by plans in the alternative subsidy program and correspondingly increased its projection of the number who will receive Part D benefits through qualified prescription drug or Medicare Advantage plans. Overall, the budgetary effects of those other revisions are largely offsetting.

Changes Related to the Low-Income Subsidy

CBO has also reviewed and refined the methods it used to prepare the original estimate of the low-income subsidy component of the Part D benefit, incorporating new data and modifying its estimate to reflect the final rule. The combined effect of those revisions to CBO's estimate of federal spending for the subsidy over the 2006-2015 period is an increase of $23 billion, resulting from:

- A reduction in the lag between when costs are incurred and outlays are made ($6.5 billion);
- Provisions in the final rule regarding how family size will be determined for individuals who apply for the low-income subsidy, in combination with refinements in estimating methods ($6.5 billion); and
- The incorporation of new income and population data in conjunction with changes in CBO's estimates of the costs of the basic benefit ($10 billion).

Payment Lag. CBO's original estimate of the cost of the low-income subsidy incorporated the assumption that the average lag between when services were furnished and when payment was made would be similar to the three-month delay that is typical for many Medicaid services. CBO now expects that lag to be one month or less. As a result, about $6.5 billion in spending that CBO had previously assumed would occur in 2016 will be brought inside the 2006-2015 period, and some spending from each year will be moved into the preceding year.

Rules for Determining Family Size and Counting Income. To qualify for the low-income subsidy, a Medicare beneficiary's income must fall below a certain percentage of the federal poverty level, which in turn varies by family size. In counting income, the Medicare Modernization Act requires that the low-income subsidy program use the same method as that used in the Supplemental Security Income (SSI) program. CBO had assumed, in estimating the cost of the low-income subsidy, that all applicants would be classified as individuals or couples—as they are in the SSI program. However, the final rule includes dependents in the determination of family size. At the same time, the rule excludes any income from those dependents from the calculation of family income. The rule's treatment of dependents will raise the relevant federal poverty level for some applicants and allow more people to qualify for the low-income subsidy. That provision, in combination with other refinements in estimating the number of individuals who qualify for the low-income subsidy, resulted in a $6.5 billion increase in CBO's projection of that subsidy's costs.

Other Changes. CBO has updated its projections of participation in Medicaid and in the low-income subsidy program to take account of new data. Those changes, in conjunction with the effects on estimated spending for the subsidy program resulting from revised projections of the cost of the basic benefit, raised CBO's estimate of the subsidy's costs by $10 billion. Two revisions based on new data account for most of that increase.

The available information now indicates that more Medicare beneficiaries have enrolled in Medicaid in recent years than CBO had expected. As a result, in projecting both Medicaid and Medicare spending, CBO has in-

creased the number of Medicare beneficiaries who are estimated to have some form of Medicaid coverage. (Those individuals will be automatically enrolled in the low-income subsidy program.) Also contributing to the hike in CBO's projection of the number of individuals eligible for the subsidy are new data indicating that low-income Medicare beneficiaries have fewer liquid assets than CBO had assumed. Accordingly, CBO has increased its projection of the proportion of beneficiaries in the Part D program who will participate in the low-income subsidy program by 2015 from 26 percent to 27.5 percent.

Regional Preferred Provider Organizations Under Medicare Advantage

CBO has raised its projection of Medicare spending by $6 billion over the 2006-2015 period as a result of its reassessment of the regional PPO component of the Medicare Advantage program, which is due to be implemented in 2006. Previously, CBO had assumed that PPOs would not be financially viable in most areas of the country.[3]

3. See Congressional Budget Office, *CBO's Analysis of Regional Preferred Provider Organizations Under the Medicare Modernization Act* (October 2004).

However, on the basis of the final rule for the Medicare Advantage program (published on January 28, 2005), CBO has revised its assessment of the likelihood that PPOs will participate in that program on a regional basis. The final rule establishes formulas for geographic adjustment of the amounts paid to PPOs that will result in payment rates in many regions that are substantially higher than CBO had anticipated.

As a result, CBO now expects that regional PPOs will be financially viable in much of the country and has increased its projection of the number of Medicare beneficiaries who will be enrolled in Medicare Advantage plans. In 2004, 4.7 million beneficiaries (11.5 percent of Part A enrollees) were enrolled in such plans; CBO now projects that the share of beneficiaries enrolled in them will grow to 16 percent by 2011 and then stabilize. (Previously, CBO had projected that enrollment in Medicare Advantage plans would remain relatively stable at about 12 percent of Part A enrollees.) That additional enrollment in regional PPOs results in higher projected Medicare spending because Medicare's payments for beneficiaries who enroll in regional PPOs will be larger than its payments for those same beneficiaries if they remain in the fee-for-service sector.

APPENDIX

B

The Administration's Proposal for Individual Social Security Accounts

In February, the Administration proposed introducing voluntary individual accounts into the Social Security system.[1] Under that proposal, workers would be able to redirect part of their payroll taxes into an account, and their retirement benefits would be reduced proportionally. The Administration suggested that the proposal would be part of a more comprehensive Social Security plan, but it has not yet identified other specific changes. Thus, the budgetary and economic impact of the overall plan cannot be estimated. In isolation, the provision for individual accounts could increase federal outlays by a total of almost $1 trillion from 2009 through 2015 if all workers chose to participate, but actual outlays would depend on the extent of participation.

Overview of the Account Proposal

Beginning in 2009, workers born in 1950 or later would be allowed to redirect 4 percentage points of the overall 12.4 percent Social Security payroll tax to an individual account, up to a maximum dollar limit.[2] That contribution limit would be $1,000 in 2009 and then increase by $100 per year plus the growth in average annual wages. Investment options and program management for the accounts would be similar to those used in the federal employees' Thrift Savings Plan, which offers a limited number of broad stock and bond index funds.

Investments in the accounts would be recorded in the federal budget as outlays, because the receipts from the designated payroll taxes would be paid into people's investment accounts instead of remaining in the Treasury. If everyone eligible for an account took part in the program, those additional outlays would total $969 billion (not including any administrative costs) over the 2009-2015 period, the Congressional Budget Office (CBO) estimates. If two-thirds of eligible workers participated, the impact over that period would fall to $646 billion (see Table B-1).[3] Should only one-third of eligible workers choose to participate, the impact would fall to $323 billion.

Factors Affecting Participation

The actual level of participation in an individual-account program would depend on the provisions of the complete proposal, including details about implementation of the accounts, the resulting value that workers would place on the accounts, and any changes to the traditional Social Security system.

Workers would base their decisions on a comparison of the benefits of having or not having an individual account. Under the Administration's proposal, the benefits from participating in the account program would be uncertain. Participants would forgo part of their traditional retirement benefits, so total benefits would be dependent on the returns earned by their account. Thus, participa-

1. Although the President's budget did not formally include a proposal for individual Social Security accounts, the Administration released a general description of such a proposal (*Strengthening Social Security for the 21st Century*, February 2005). Further details were included in a February 3 memo from Stephen Goss, Chief Actuary of the Social Security Administration, to Charles Blahous, Special Assistant to the President for Economic Policy.

2. In 2009, only people born between 1950 and 1965 would be eligible to participate. In 2010, eligibility would be expanded to people born through 1978; and beginning in 2011, anyone born in 1950 or later could participate.

3. The Social Security actuaries estimate that total costs would be $671 billion through calendar year 2015 if two-thirds of eligible workers participated.

Table B-1.

The Budgetary Impact of Individual Social Security Accounts

(Billions of dollars)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2015
Share of Eligible Workers Participating											
All	0	0	0	36	88	132	155	171	186	201	969
Two-thirds	0	0	0	24	59	88	103	114	124	134	646
One-third	0	0	0	12	29	44	52	57	62	67	323
None	0	0	0	0	0	0	0	0	0	0	0

Source: Congressional Budget Office.

tion would be affected by the size of the reduction (or "offset") in traditional benefits. The larger that offset, the less likely workers would be to take part. The offset envisioned in the President's proposal is based on a real (after-inflation) return of 3 percent. If account holders realized a higher rate of return, their total retirement benefits would be larger; if they realized a lower return, their total benefits would generally be smaller.

A central issue is the role of investment returns in such accounts. On the basis of historical patterns and likely future economic conditions, CBO assumes that the real return on Treasury securities will average 3.3 percent in the future, whereas the comparable return on stocks will average 6.8 percent. But stocks also carry higher risk.

When choosing investments, investors evaluate the opportunities for low returns (and low risk) versus higher returns (and higher risk) and select a balance of stocks and bonds that suits their individual tolerance for risk. Investors who have a very high tolerance for risk purchase mostly stocks; others are willing to accept a lower expected return in exchange for the relative safety of bonds. In the process, investors' purchases reveal their current valuation of potential future returns and risks. The market prices of stocks and bonds indicate how those securities are valued by investors, including individuals and pension funds.

The fact that the market value of $100 worth of bonds and $100 worth of stocks is identical means that investors value the net effect of the higher risk and return of stocks as equal to the lower risk and return of bonds. For that reason, one can use the expected return on government bonds as a guide to the current value of an account that would influence a typical worker's decision about participation.

Many other factors, however, would also affect participation decisions:

- *Interactions with the traditional benefit structure.* The offset included in the Administration's proposal would reduce traditional retirement benefits on the basis of contributions to an account. If all else was equal, that provision would make the accounts less attractive and reduce participation. However, if changes to the Social Security system significantly lowered traditional benefits, the maximum benefit offset might be smaller, encouraging participation.

- *Rules for inheritance.* Allowing workers to include part or all of an individual account in their estate would encourage participation, especially if they could choose to leave their balance to their heirs without having their traditional Social Security benefits offset, as would occur if they drew from the account directly.

- *Guaranteed returns.* If the government guaranteed that the accounts would earn a certain return, more workers would participate.

- *Tax treatment.* If the returns in the accounts were taxed at a lower rate than other investments, participation would rise.

- *Timing of withdrawals.* Allowing participants to have flexibility in when they could make withdrawals from

their account would encourage participation, especially if it gave people the opportunity to leave larger estates.

- *Automatic enrollment.* Participation rates would be sensitive to the administrative structure of the accounts. If workers were automatically enrolled, participation would be higher than if enrollment required some action on their part.

APPENDIX

C

The Potential Economic Effects of Selected Tax Proposals in the President's 2006 Budget

Three provisions of the President's 2006 budget—the proposals to extend dividend and capital gains tax rates under the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) beyond 2008, to expand the availability of tax-free savings accounts, and to extend the repeal of the estate tax—have especially complex economic effects. Discussed below are the factors that the Congressional Budget Office (CBO) considered and the methods it used in assessing those impacts. (CBO's analysis of the overall economic effects of the President's budgetary proposals is described in Chapter 2.)

Extend JGTRRA's Dividend and Capital Gains Tax Rates

In 2003, JGTRRA reduced the tax rates applicable to both dividends and capital gains for 2003 through 2008. Those rates comprise a bottom bracket of 5 percent and a top bracket of 15 percent; in 2008, the bottom bracket is slated to drop to zero. Before JGTRRA was enacted, dividends were subject to the same tax rates as ordinary income—ranging from 10 percent to 35 percent—and most capital gains were subject to rates of 8 percent, 10 percent, or 20 percent. The President, in his 2006 budget, is proposing to make the zero and 15 percent rates permanent.

Such reduced rates lower the overall taxation of corporate profits. Some corporate profits are taxed once under the corporate income tax and then again, when people receive dividends and realize capital gains—brought about by the firm's reinvesting of its profits—on sales of stock. Lowering the tax rates that individuals face on the two types of income reduces the total rate of taxation.

JGTRRA's tax rates not only reduced the taxation of corporate income but also decreased taxes on some income that is currently taxed only once. A substantial portion of taxable capital gains arises from investments whose earnings are not subject to the corporate income tax, such as gains on real estate held by individuals. The lower capital gains tax rate cut the level of taxation on those investments as well.

To some extent, the economy is already feeling the effects of the tax rates on dividends and capital gains under JGTRRA. However, the currently short duration of those rates lessens their effect on investment and the capital stock. Investments in productive capital take time to implement, and firms are unlikely to adjust their long-term investment plans fully in response to temporary changes in dividend and capital gains taxation. Thus, some portion of the impact of the current rates can be expected to occur only if the proposed extension of those rates takes effect.

One such impact involves the cost of financing for businesses. By reducing the overall taxation of capital income, a drop in taxes on dividends and capital gains might be expected to lower that cost because businesses could pay investors less before taxes to yield the same after-tax return. But how much the cost of capital might fall is unclear. Some analysts argue that the reduction in the cost of capital will reflect only the decrease in taxes on capital gains. Others hold that the reduction will reflect the fall in taxes on both gains and dividends.[1]

Corresponding to the disagreement among analysts about the size of the drop in the cost of capital is a difference of opinion about how much the values of firms' stock might

1. See George R. Zodrow, "On the 'Traditional' and 'New' Views of Dividend Taxation," *National Tax Journal,* vol. 44, no. 4, part 2 (December 1991), pp. 497-509.

rise. (Share values rise because the decrease in taxes increases the after-tax return to shareholders.)[2] The view of corporate finance that predicts a relatively large increase in those values predicts a relatively small decrease in the cost of capital, and vice versa.

In the absence of a consensus about which view is correct, CBO has adopted a middle-ground estimate of the effects of the President's proposal on the cost of capital for firms and on share values.

High values for shares of stock lead to more consumption among shareholders (the so-called wealth effect). Therefore, the President's proposal will help boost overall demand in the short run. But the more it helps demand by raising consumption, the more it will hurt supply in the long run, by lowering saving and investment.

Another impact of extending the rates on capital gains and dividends is that it is likely to lessen the disadvantage that the corporate sector now faces in the competition for capital. For example, although some income from the corporate sector is taxed twice under current law, income from unincorporated businesses is taxed only once (at the personal level), and the value of housing "services" provided by owner-occupied housing is not taxed at all. That disparity in tax treatment leads to less investment in the corporate sector than may be optimal for economic output. Lowering the taxes that firms face would allow them to attract additional capital from the housing and small-business sectors and in general improve the economy's efficiency. Such a shift in investment might, however, conflict with other policy goals, such as support for owners' occupancy of homes or for unincorporated businesses.

Yet another impact of the proposal is that it would affect firms' financial behavior in two ways: it would make equity financing more attractive relative to debt financing, and it would make the payment of dividends more attractive relative to the retention of earnings. Currently, firms can deduct the interest they pay on debt from their taxable income, so those payments are taxed only once, at the personal level. (That is, the individual who receives the payment pays the tax.) But if a firm finances a project by issuing stock (equity financing), some of the returns on the investment that the project generates are taxed at both the corporate and personal levels. The President's proposal would narrow that disparity in tax treatment.

The proposed reduction in the future taxation of dividends and capital gains would also interact with some of the President's other proposals and with current law. For instance, the President's proposal to boost the amount that people could deposit in tax-free savings accounts (discussed below) would increase the share of personal assets held in such accounts—duplicating some of the effect that the proposal to extend the tax rates on dividends and capital gains would have on the cost of capital and on its allocation among sectors of the economy. However, the expanded accounts would partly undo the impact that the dividend/capital gains proposal would have in bolstering equity financing, because the interest earned on assets in the accounts would not be taxed at either the personal or the corporate level. That lessening of the proposal's impact on equity financing would be intensified by the combined effect of the two policies in increasing the proportion of interest-bearing assets in tax-free accounts: the incentive to hold equities in such accounts would be weakened if their returns already faced lower tax rates.

CBO incorporated the effects of the dividend/capital gains proposal in its analysis in two ways. For the two macroeconometric models, CBO estimated the proposal's effect on the cost of capital in different sectors of the economy and on the values of stock shares under the assumption that both investors and businesses would be forward-looking. It then incorporated those estimates in the models and projected the ultimate effect on the economy.

For the growth models, CBO estimated the proposal's overall effect on the average cost of capital and incorporated that calculation. Those models, however, have no mechanism to take account of the effect of the reallocation of capital. CBO therefore reviewed research on how reallocation might influence output, determined a midrange estimate, and added that amount to the models' underlying estimates of the effect on output. The procedure added an average of 0.07 percent over the 2006-2015 period to the proposal's projected effect on gross domestic product in the models.

2. Over time, however, increased investment will enlarge the capital stock, in turn reducing the pretax rate of return and offsetting at least some of the impact of the reduction in taxes.

Expand Tax-Free Savings Accounts

The President's 2006 budget includes a proposal that is designed to both consolidate and expand the current system of tax-free savings accounts for retirement and other purposes, such as education. Two new kinds of accounts would be created: retirement savings accounts (RSAs) and lifetime savings accounts (LSAs). The RSA would function in some ways like a Roth individual retirement account (IRA)—that is, taxes would not be deferred on contributions, as they are for contributions to traditional IRAs, but the interest that the accounts earned would accrue tax-free. In contrast to Roth IRAs, however, RSAs would be available to all workers (and their spouses) regardless of income; they would also have higher limits on contributions and allow penalty-free withdrawals at a slightly earlier age. In addition, the proposal would eliminate further tax deferrals for IRA contributions.

Like the RSAs, the proposed lifetime savings accounts would face tax treatment similar to that governing Roth IRAs. However, unlike Roth IRAs or RSAs, LSAs would be open to everyone, regardless of age, income, or employment status, and participants could withdraw funds at any time for any reason. Taxpayers could also use LSAs to consolidate other savings plans, including Coverdell education savings accounts and qualified state tuition plans.

In CBO's estimation, the new savings accounts that the President has proposed would have little effect on the economy, on average, through 2015. Most taxpayers would simply save the same amount in one of the new accounts as they would have saved in one of their present tax-free accounts. One possible outcome of implementing the new accounts is that people who currently have assets in taxable accounts will reduce their tax liability by selling those assets and putting the cash from the sale into the new accounts. However, that action would create no new saving and thus would have no effect on the total amount of private saving. Most new saving would involve small amounts set aside by taxpayers with few taxable assets to shift.

Beyond 2015, the effects of the proposal could be greater than those just described (because more and more taxpayers would run out of assets that could be shifted). In those years, CBO estimates, the proposal would have a modestly positive impact on saving.

Extend the Repeal of the Estate Tax

The President's proposal to extend the repeal of the estate tax beyond the end of 2010 (its scheduled expiration date) could have varying effects on consumption and saving, depending on people's motives for leaving bequests. There is little consensus about which motives predominate or even about whether bequests are typically the result of a deliberate saving plan. If they are not, the repeal of the estate tax will not encourage saving. Moreover, analysts who believe that estate taxes affect consumption and saving disagree about the direction of that effect. A lower estate tax makes it cheaper for people to leave money to their heirs, which could encourage people to save more to leave larger bequests. But a lower estate tax also means that people can leave the same after-tax bequest with a smaller amount of savings, which might induce them to save less. Furthermore, to the extent that a lower estate tax increased the size of bequests after taxes, potential recipients might increase their consumption. Some opponents of the estate tax argue that it has a particularly negative effect on the creation of new small businesses, but there is little evidence to support that contention.

The models CBO used to estimate the effect of the President's proposal incorporated the assumption that extending the repeal of the estate tax would increase consumption slightly, on balance, by about 5 cents for each dollar of tax savings.[3] That assumption implies that the extension of the repeal will reduce the capital stock but by an amount too small to affect the estimates presented in Chapter 2 of this report. Alternative assumptions that CBO considered—for example, that the positive effect on consumption from increasing after-tax income is exactly balanced by the incentive effects of lower tax rates, yielding no net impact on consumption—would have yielded similar results.

3. CBO assumed that consumption would increase by only a small amount because recipients of larger after-tax bequests would be unlikely in any given year to raise their spending by a significant amount and because the effect on recipients might be offset to some degree by increased saving among those planning to leave bequests.

APPENDIX

D

The Models Used to Analyze the Macroeconomic Effects of the President's Budget

The Congressional Budget Office (CBO) used three models to estimate the supply-side effects of the President's budget from 2006 to 2015: a "textbook" growth model, a life-cycle growth model, and an infinite-horizon growth model. (The estimates that those models generated are presented in Chapter 2.)

The textbook growth model, which CBO uses to project the economy's potential output for the agency's 10-year economic baseline, is an enhanced version of a model developed by Robert Solow, a pioneer in the theory of growth accounting.[1] The textbook growth model assumes that output is determined by the number of hours of labor supplied by workers, the size and composition of the capital stock (for example, factories and information systems), and total factor productivity—which represents the state of technological know-how. The model is not forward-looking; people base their decisions entirely on current economic conditions. In particular, they do not respond to expected future changes in government policy. Nor does the model incorporate effects from demand-side, or cyclical, variations in the economy. Rather, it assumes that output is always at its potential level.

The estimates that CBO developed using the textbook growth model incorporate the effects of the changes in marginal tax rates specified in the President's budget on the number of hours worked. (CBO estimated the tax-rate effects in a separate calculation.) Those effects are greatest from 2011 through 2015, when lower marginal tax rates would increase the supply of labor relative to the level in CBO's baseline.

1. For a detailed description of the textbook growth model, see Congressional Budget Office, *CBO's Method for Estimating Potential Output: An Update* (August 2001).

The President's budgetary proposals are estimated to have a negative effect on the capital stock in the textbook growth model. The proposals would increase after-tax income relative to that in the baseline, which would lead to increased private consumption that crowded out investment. In the textbook growth model, changes in marginal tax rates on capital have no direct effect on spending by the private sector.

The negative effects on the capital stock would be partially offset by two factors, for which the model includes assumptions based on past relationships. First, the increase in private consumption is moderated by the assumption that people increase their private saving by 40 cents for every dollar that the deficit increases. Second, for every dollar that national saving falls (national saving equals private plus government saving), the amount of foreign capital invested in the United States is assumed to increase by 40 cents.

The life-cycle and infinite-horizon growth models that CBO also used in its supply-side analysis differ in fundamental ways from the textbook growth model.[2] The life-cycle and infinite-horizon models incorporate simulated people who make decisions about how much to work and save in order to make themselves as well off as possible over their lifetime. Their behavior is calibrated so that macroeconomic variables such as the total amount of labor supplied and the size of the capital stock match the

2. For a detailed description of the life-cycle model, see Shinichi Nishiyama, *Analyzing Tax Policy Changes Using a Stochastic OLG Model with Heterogeneous Households*, Technical Paper 2003-12 (December 2003). For a detailed description of the infinite-horizon model, see Tracy Foertsch, *Macroeconomic Impacts of Stylized Tax Cuts in an Intertemporal Computable General Equilibrium Model*, Technical Paper 2004-11 (August 2004).

levels that occur in the U.S. economy. In the life-cycle and infinite-horizon growth models, people's consumption changes by a relatively large amount in response to changes in the after-tax rate of return on their saving. Like the textbook growth model, those models do not allow for any demand-side effects.

The people in the life-cycle and infinite-horizon models are assumed to be forward-looking—that is, they know how economic conditions and policy will change in the future and alter their behavior accordingly. In terms of the degree to which people incorporate future events into their current behavior, that "perfect foresight" is at the other end of the range of possible assumptions from the assumption used in the textbook growth model. Most people's foresight actually falls somewhere between those two extremes. However, in using those two somewhat dramatic assumptions, CBO has tried to encompass as broad a range of possible responses to the President's budgetary proposals as is feasible.

Because people's behavior as represented in the life-cycle and infinite-horizon growth models depends in part on future policies, the use of those models requires analysts to make assumptions about budgetary policies beyond 2015 (the end of the period covered by CBO's current 10-year baseline projections). Policies that increase deficits must be offset at some point in the future by taxes that are higher or spending that is lower than it would have been in the absence of the higher deficits.

Assumptions about how and when to offset the bill that comes due can influence the estimated economic effects of the President's proposed policies over the 2006-2015 period. That impact stems from the fact that in the models, people anticipate the offsetting policies and plan accordingly. In its analysis, CBO used two different assumptions about how the budget would be stabilized after 2015: either marginal tax rates would be increased, or government consumption of goods and services (which the models assume does not enhance people's well-being) and transfer payments would be cut. The size of the cuts in those two categories that the models incorporate is proportional to the relative size of transfer payments and government consumption in CBO's baseline for 2015, an assumption that implies that the cuts would be roughly equal. Both the increase in marginal tax rates and the cuts in government consumption and transfers are assumed to be phased in over 10 years, beginning in 2016.

The life-cycle and infinite-horizon growth models differ in what they assume about how far ahead people look in making their plans. The life-cycle model is calibrated so that the probability of death at a given age matches current U.S. mortality rates, and people are assumed to take account of the impact of future economic or policy changes only on themselves and not on their children. In the infinite-horizon model, people behave as though the well-being of their descendants is as important to them as their own well-being. That leads them to behave as if they expected to live forever. Although the possibility that such an assumption reflects actual behavior cannot be ruled out, there is some evidence against it.[3]

The difference in the models' time horizons has an important effect on the resulting estimates. The people in both models expect the increase in deficits under the President's budgetary proposals to be offset at some point in the future. However, people as represented in the life-cycle model, especially older individuals, know that they may die before an offsetting policy change occurs. Consequently, they may be less willing to work or save more during the 10-year projection period to compensate for any future tax increases or cuts in transfer payments.

By contrast, people in the infinite-horizon model act as though they (or, equivalently, their descendants, whom they care about as much as they do themselves) will be alive when the offsetting policy change is made. That expectation implies that a belief that taxes will increase in the future has a greater effect on their current work and saving than it does on the corresponding variables for people in the life-cycle model. For that reason, the most positive estimates of the effect of the President's budget on the economy within the current budget window (2006 through 2015) are produced by the infinite-horizon model using the assumption of future tax increases.

CBO used two different assumptions in the life-cycle model about how open the economy is to flows of capital

3. See Joseph G. Altonji, Fumio Hayashi, and Laurence Kotlikoff, "Risk Sharing Between and Within Families," *Econometrica*, vol. 64, no. 2 (March 1996), pp. 261-294; Paul Evans, "Consumers Are Not Ricardian: Evidence from Nineteen Countries," *Economic Inquiry*, vol. 31, no. 4 (October 1993), pp. 534-548; and T.D. Stanley, "New Wine in Old Bottles: A Meta-Analysis of Ricardian Equivalence," *Southern Economic Journal*, vol. 64, no. 3 (January 1998), pp. 713-727.

to and from other countries. One assumption was that the economy is completely closed—no capital can flow into or out of the United States. The other assumption was that the economy is completely open and cannot affect world interest rates—capital flows freely into and out of the country to keep the domestic interest rate equal to a constant world rate. The U.S. economy effectively operates somewhere between those two extremes, because although it is relatively open to investment, it is so large that it can influence world interest rates.

APPENDIX

E

Contributors to the Revenue and Spending Projections

The following Congressional Budget Office analysts prepared the revenue and spending projections in this report:

Revenue Projections

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Mark Booth	Individual income taxes
Paul Burnham	Retirement income
Barbara Edwards	Social insurance taxes, Federal Reserve System earnings
Seth Giertz	Health and education taxation
Pamela Greene	Corporate income taxes, estate and gift taxes
Laura Hanlon	Excise taxes
Ed Harris	Corporate income taxes
Rob McClelland	Estate and gift taxes
Larry Ozanne	Capital gains realizations
Monisha Primlani	Individual income taxes
Kurt Seibert	Earned income tax credit
David Weiner	Individual income taxes
Dennis Zimmerman	Tax-exempt activities

Spending Projections

Defense, International Affairs, and Veterans' Affairs

Jo Ann Vines	Unit Chief
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Sunita D'Monte	International affairs (conduct of foreign affairs and information-exchange activities), veterans' housing
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Deborah Kalcevic	Education
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